INSURANCE REGULATION AND COMPETITION FOR THE 21ST CENTURY

HEARINGS

BEFORE THE

SUBCOMMITTEE ON
CAPITAL MARKETS, INSURANCE, AND
GOVERNMENT SPONSORED ENTERPRISES

OF THE

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WITNESESS

Tuesday, June 18, 2002

APPENDIX

Additional Material Submitted

INSURANCE REGULATION AND COMPETITION FOR THE 21ST CENTURY

Tuesday, June 4, 2002

U.S. House of Representatives,
Subcommittee on Capital Markets, Insurance
and Government Sponsored Enterprises,
Committee on Financial Services,
Washington, D.C.

The subcommittee met, pursuant to call, at 2:00 p.m., in Room 2128, Rayburn House Office Building, Hon. Richard H. Baker [chairman of the subcommittee] presiding.

Present: Representatives Baker, Ney, Shays, Royce, Ose, Rogers, Biggert, Hart, Kanjorski, Bentsen, Sherman, Moore, Lucas of Kentucky and Israel.

Chairman Baker. I would like to call this meeting of the Capital Market Subcommittee to order. The meeting today is the first in what will be a series of meetings over the coming weeks to assess the advisability and desirability of reform in the marketing of insurance products nationally. In the course of facilitating what we hope will be an important resolution of these issues is a significant number of panelists who, over a period of weeks, will each give perspectives from their particular assessment of the advisability of any approach that should be considered by the committee.

In the course of this, I am certain the committee will learn a great deal, as we have a number of perspectives represented in the course of all of the hearings. While we have no specific purpose in mind for the end conclusion of these hearings, it certainly is evident that some regulatory reform is in order where a regulated financial institution may market a product which, on its face, is not called insurance, but, in effect, is insurance that is not subject to the 50-State review process and can enter into the marketplace rather freely.

A similar product labeled insurance by an insurance company must go through a rather long and deleterious process in order to see that product marketed in like fashion. There are many other instances which may be of concern, and I am certain the witnesses today will bring many to our attention. But this is a first step in what I hope will lead to a conclusion before the end of this Congress in some legislative recommendation for action that the committee may consider.

Chairman Baker. At this time I would like to recognize Mr. Kanjorski for an opening statement.

Mr. Kanjorski. Thank you, Mr. Chairman. Today we meet for the first time this year to discuss the insurance industry and the challenges that it faces. I commend you for your diligence in convening this series of hearings. Your efforts to educate the members of our committee about insurance regulation will potentially serve as the basis for future legislative action. I suspect, however, that it will take us at least several years to forge a consensus on this complicated set of issues.

The American insurance industry, as you know, is broad and diverse. According to one estimate, we have approximately 5,763 insurance companies operating in the United States. These companies vary greatly in size, structure, and product offerings. For the last 150 years, the States have also traditionally regulated these insurers.

Nevertheless, a discussion of insurance regulatory reform, including various proposals designed to increase the efficiency, promote the uniformity of insurance regulation, or create an optional Federal charter, flows naturally from our actions in the 1999 law to modernize the financial services industry. That statute removed the obstacles that prevented banks, securities firms, and insurers from affiliating and competing with each other. It also provided for the regulation of financial products by function, rather than by institution. Additionally, that law reaffirmed the McCarran-Ferguson Act of 1945, which calls for the regulation of insurance at the State level.

The 1999 reform law has also begun to change marketplace dynamics. In fact, a number of insurers have reported that they increasingly find themselves in direct competition with brokerage firms, mutual funds, and commercial banks, all of which may have a competitive advantage due to their arguably more efficient federally-based regulatory systems. For example, in many instances, a bank may introduce a new product immediately without any action by their regulator, and securities firms can typically bring new products to market within 90 days. Insurers, however, sometimes have to wait more than a year to secure all of the required approvals to offer a new product nationwide.

As a result of these and other changes, some now contend that the current regulatory system for the insurance industry has become too cumbersome and requires reform. For example, a recent study by the American Council of Life Insurers concludes that the lack of uniformity in State laws, the burden of dealing with numerous jurisdictions, and the excessive time required for new product approval are of paramount concern of insurers who want to compete nationally.

In response to these mounting criticisms of State insurance supervision and the growing recognition that market forces have changed the financial services industry, the States have initiated their own efforts to modernize insurance regulation, primarily through the National Association of Insurance Commissioners.

This debate over how to reform insurance regulation has also seeped into Congress. Earlier this year, our colleague, Congressman John LaFalce, introduced H.R. 3766, the Insurance Industry Modernization and Consumer Protection Act. His bill would allow insurers to obtain an optional Federal charter and afford consumers with various protections. As we begin our series of hearings, I want to commend my ranking member for his leadership on this important issue.

From my perspective, the most important thing that we can do in the short term to help the insurance industry is to pass legislation to provide a Federal terrorism reinsurance backstop until the private sector can address the problem. In the long term, we should also explore how to modify insurance regulation and whether we should create an optional Federal charter.

One idea that merits our consideration is whether we should create a tiered regulatory structure for the insurance industry as we have already done for investment advisors. The Federal Government would regulate insurers above a certain size or in certain business lines, while States would retain the responsibility for regulating the rest. During these debates, we should also carefully examine consumer protection issues. In the end, consumers should be the ultimate beneficiaries of our actions.

In closing, Mr. Chairman, I believe it is important that we learn more about the views of the parties testifying before us today. Their comments will help us to better understand the different approaches to reforming insurance regulation and the key challenges the industry faces. I also look forward to working with you over the coming weeks and months as we proceed with additional hearings to examine today's evolving insurance marketplace and the need for regulatory reform.

Chairman BAKER. Thank you, Mr. Kanjorski.

[The prepared statement of Hon. Paul E. Kanjorski can be found on page 140 in the appendix.]

Chairman BAKER. Mrs. Biggert.

Mrs. BIGGERT. Thank you, Mr. Chairman. As we are all aware, financial services reform, technology and globalization have dramatically changed the marketplace, and as such, we need to bring insurance regulation in the 21st century to adjust with the environment in which we now live and work.

Two questions immediately come to mind. First, what is the best path to follow; and second, why should we adjust with the times in the first place?

Well, we are here today to help answer the questions of the best way to proceed, and in terms of the why, we simply must change in order to guarantee that American product innovation and competition remain the gold standard to which others around the world strive to imitate.

Mr. Chairman, many times our States provide the best guidance for us to follow as we consider laws at the Federal level, and this is one of those times. In my home State of Illinois, our system has worked well for insurers, consumers and regulators alike. Illinois has a very small residual market, and significantly more auto and homeowners competing for business than States with stringent price regulation. Consequently, the premiums and lost wage ratios in my State are well below most other States with large populations, high traffic density, and urban centers of activity.

Importantly, this system of less regulation has freed up government resources to allow State insurance departments to redirect regulatory attention where it is most needed, including effective solvency regulation and rehabilitation or liquidation of troubled companies. Many argue that any action Congress may take should bring about a system that resembles the one found in Illinois. We will hear some of those arguments this afternoon.

While I believe that both the States and the Federal Government have a role in regulatory affairs, there definitely are some industries that the Federal Government should not touch with a 10-foot pole. Whether or not the insurance industry falls into that category, I do not yet know. That is why we scheduled this series of hearings: to listen, to ask questions, and to examine the issue a little closer.

So let me offer a special welcome to the Alliance of American Insurers, an organization with its headquarters in Downers Grove, Illinois. For over 75 years, the Alliance has faithfully provided property and casualty coverage to thousands of policyholders, and I know that the Alliance's Ann Spragens is well regarded in the insurance world and will have some important things to say about the current and future state of insurance regulation. So I look forward to hearing from her and the other witnesses that are here.

Thank you, Mr. Chairman.

Chairman BAKER. Thank you, Mrs. Biggert.

Chairman BAKER. Mr. Bentsen.

Mr. BENTSEN. Thank you, Mr. Chairman. Thank you for calling this hearing and the subsequent hearings that will come from this. The chairman and the ranking member will remember that over the last several years, as this committee struggled with the passage of financial modernization, we often stumbled over the fact that because of McCarran-Ferguson and the fact that insurance is the only financial product which is not regulated really in any form or fashion at the Federal level, that it made it very difficult for us to achieve financial modernization. We ultimately did, and some would argue that as a result of that, we chipped away at McCarran-Ferguson.

But I think that the chairman is very prescient in calling this hearing and pursuing this matter, because I think we have come to the realization that as it is for securities and as it is for other financial products, the same is true for insurance, that it is not—the United States is not a conglomeration of 50 different markets, but rather, we are 50 different States that are subdivided among 50 different regulators, and that may well not be the most efficient means by which to both deliver a product to consumers and also ensure that consumers are adequately protected.

This will be a very difficult issue. I would presume that one, I hope that the committee pursues and follows through on, but I think Mr. Kanjorski is right, it is probably an issue that will take some years to accomplish, but I think it is a step in the right direction, and I think that the committee and the Congress should go into this with their eyes open, understanding that market forces are going to require us to move in this direction, that we have also shown through experience that you can have a dual regulatory structure at the Federal and State level which adequately protects consumers, and we should not be concerned in trying to create a similar structure for the insurance market.

So I appreciate the chairman calling this hearing.

Chairman BAKER. Thank you, Mr. Bentsen.

Chairman BAKER. I welcome our panelists here this afternoon. I certainly appreciate each of your participation.

Chairman BAKER. At this time, I would introduce Mr. Wayne White, President and Chair of Home Mutual Fire Insurance Company, who is here today on behalf of the National Association of Mutual Insurance Companies. Mr. White.

STATEMENT OF WAYNE WHITE, PRESIDENT AND CHAIRMAN, HOME MUTUAL FIRE INSURANCE COMPANY, ON BEHALF OF THE NATIONAL ASSOCIATION OF MUTUAL INSURANCE COMPANIES

Mr. WHITE. Thank you, Mr. Chairman.

Chairman Baker and members of the subcommittee, it is an honor to have the opportunity to address you at this hearing on insurance regulation and competition for the 21st century. My name is Wayne White, and I am President and Chairman of Home Mutual Fire Insurance Company in Conway, Arkansas. I come before you as a representative of the 1,300 members of the National Association of Mutual Insurance Companies. NAMIC is the largest property and casualty trade association.

I have been asked to discuss insurance regulation, including a perspective on the National Association of Insurance Commissioners, advisory organizations such as the Insurance Services Office; rating organizations such as A.M. Best, Standard & Poor's; and finally, to provide you with NAMIC's position on the future of insurance regulation. Each of these issues are discussed at length in my written testimony.

NAMIC is encouraged by the NAIC's post-GOBA performance with respect to the mandated tasks, as well as to the statement of intent. The NAIC also deserves recognition for focusing attention on key marketplace improvements, such as speed to market and market conduct for which NAMIC member companies are asking. While the NAIC can recommend standards for reform and raise the profile of important market reform issues, they cannot act alone. In the final analysis, before Congress intercedes, State legislative action must be the focus of modernization initiatives.

There are important and effective national organizations that are prepared to lead this reform effort in the States. Already, the American Legislative Exchange Council, ALEC, the National Conference of Insurance Legislators, NCOIL, have endorsed competitive rating language that satisfies the speed to market concerns of the property casualty insurance industry.

This Friday in PhiladelpHIAA, the National Conference of State Legislature's executive committee task force to streamline and simplify insurance regulation will meet to consider State legislative options for speed to market and market conduct reform. Their proposals will be approved by this fall so that the States may be considering these issues in January.

Other organizations have played significant roles in the evolution of insurance practices. Rating bureaus came into being in the late 1800s and operated without disruption until the enactment in 1945 of McCarran-Ferguson, which recognized the authority of the States to preempt Federal antitrust legislation and laws and regulate insurance rates and forms. The role of rating bureaus has changed and their rates and forms require regulator endorsement, thus giving birth to the prior approval process currently in effect in more than one-half of the States.

Today, these bureaus are transforming to advisory organizations and gather premium and loss data for State regulators and the public as well. They also promulgate standardized forms for use by companies that affiliate with them. Rating organizations provide another piece of the regulatory puzzle. These independent organizations provide ratings of insurance companies based on financial and operational analyses, and give regulators an additional perspective on the companies licensed in their jurisdictions.

The information presented today should make our position clear. The regulation of the insurance industry is best left to the States. The issues we are dealing with are not new, but have simply gained a higher profile as a result of the convergence of the financial services industry. A recently released public policy paper, Regulation of Property Casualty Insurance, the Road to Reform, outlines the major items in need of regulatory attention.

In addition, it points out the flaws in a Federal solution to insurance regulation, flaws such as the propensity of Federal bureaucracies to use the regulatory process as a means of social engineering; the potential for an unfair environment for smaller companies; the additional costs associated with a dual regulatory system that must still deal with the tort laws that are unique to the individual States, and recognition that the cost of such a system will be passed on to the consumer. Many of the issues put on the table by those desirous of Federal involvement are simply of such a purpose as to make it easier for large companies to do business.

The areas for reform have been clearly defined. However, we must remember that changes in regulations and business practices are driven by consumer demand. It is at that level which is closest to the consumer that the process of change is most effective. Now it is up to the States to enact changes in public policy that will make the difference, and we urge you to give it time to work.

Chairman BAKER. Thank you, Mr. White.

[The prepared statement of Wayne White can be found on page 198 in the appendix.]

Chairman BAKER. Our next witness is no stranger to the committee room for sure. Welcome, Mr. Steve Bartlett, President of Financial Services Roundtable and a former distinguished member of this committee. Welcome, Mr. Bartlett.

STATEMENT OF STEVE BARTLETT, PRESIDENT, FINANCIAL SERVICES ROUNDTABLE

Mr. BARTLETT. Thank you, Chairman Baker and Ranking Member Kanjorski and members of the committee. It is good to be here.

The Financial Services Roundtable greatly appreciates the opportunity to participate in what I believe will turn out to be the first of blockbuster hearings in this area. I am here on behalf of our 100 member companies and their CEOs who identified the creation of an optional Federal charter for insurance companies as a top priority of the industry on the date of our inception as we reconstituted an integrated trade association. They identified this as a top priority on day one of the organization, Mr. Chairman, back in 1999.

We believe it is time, Mr. Chairman and Mr. Kanjorski and members of the subcommittee, to create order out of chaos, to unleash the genius of the competitive marketplace, and to allow a national market to function as a national market in conjunction with regulation, not in spite of it. In short, it is time for Congress to create an optional Federal charter; not tomorrow or next year or 5 years from now, but now.

In inviting the Roundtable to testify, you have asked us for an overview of the economic and marketplace challenges facing the insurance industry, which I shall do. As a predicate to that, though, I would like to make four quick points:

First, as these hearings will reflect, and please note from all of the witnesses, there will be no real disagreement about the need for significant reform in modernization. I do not believe anyone will come to you and say there is not a problem to be fixed.

Second, perhaps most important, the optional Federal charter and legislation aimed at improving State regulation are mutually complementary rather than mutually exclusive. They can and should be combined into a single, integrated piece of legislation.

Third, modernization of insurance regulation is about the economy and our customers, the American consumers, your constituents; not about turf battles, not about barriers, not about all of those things around it, but it is about the consumers.

Finally, Congress can ill-afford, I believe, to wait for a crisis to prompt comprehensive reform.

Now, the marketplace challenges. The direct and indirect cost to national companies of dealing with the inconsistent laws and regulatory requirements of 55 different regimes are enormous. These costs are today borne by customers and reflected in industry profitability. In my written testimony I have provided some of those estimates. It is profitability, after all, that allows our companies to offer products and services at the lowest possible cost to the consumer. In the year 2000, Mr. Chairman, the property casualty rate of return, known as ROR in the industry, was 5.8 percent, and for life insurance was 10 percent.

By contrast, the rate of return for commercial banks was 16.7 percent, and the rate of return for diversified financial services companies was 21.3 percent, and for the Fortune 500 overall was 14.6 percent. Again, that is contrasted with 5.8 percent for property and casualty.

The myth that insurance companies are wildly successful and overcapitalized is precisely that: a myth. Since its peak in 1999, the capital of the U.S. nonlife industry has declined by $58 billion, or 17 percent. The ratio called the trade combined ratio, or TCR, which is the ratio of an insurance company's losses and expenses to its premiums is one way to view profitability. In 2000, the trade combined ratio was 116. That means that these companies are paying $1.16 out for every dollar they earn in premium. Clearly, under the current system, insurance companies are not as healthy as others in the financial services sector.

In fact, it is reasonable to assume that under the current State-based system, diversified financial services companies will continue to steer away from insurance as a core business. The true cost of State-based regulation is manifested in the resulting lack of competition and choice for consumers. Companies cannot indefinitely pay out much more in cost and losses than they receive in premium while continuing to serve their customers properly. Consumers ultimately will bear their cost in reduced choice and convenience.

On the regulatory consequences side, Mr. Chairman, the fact is that the existing regulatory structure adds a tremendous cost burden on insurers and consumers and, at the same time then, stifles competition. The need to get individual State approvals, for example, for products, mean not only long delays in bringing products to market; in some jurisdictions this can take years, but also huge costs associated with time, complexity, and duplication due to the differing requirements and standards of 55 different jurisdictions, even though in the case of many national companies, it is one product and the same consumers.

The NAIC has invested enormous time and effort into seeking to reform the system. We applaud those efforts and support those efforts. But these reforms towards uniformity absent an optional Federal charter of a competitive Federal charter simply cannot succeed. The world is different from where it was 57 years ago when McCarran-Ferguson was enacted. Unlike that time, the United States is now a single national market for all financial services, including insurance. The world has changed a lot in 57 years. As in every other industry, insurance companies that operate on a national basis should be able to choose one-stop regulation that is free of duplication, redundancy, and inconsistent requirements and interpretations.

The principles that we have chosen to lay out, Mr. Chairman, are briefly, first, any Federal system that must be consistent with effective, high-quality State insurance regulation; second, any framework of Federal regulation must be truly optional; third, a Federal charter should be designed to permit insurance companies of all sizes and types to engage in multi-State operations; fourth, a new Federal framework must represent the best in modern regulation, and that means deregulation of rate and form; fifth, the system should be comprehensive; sixth, the new Federal regulators should have the stature and resources appropriate to the task.

Mr. Chairman, thank you for your boldness in holding these hearings and for your commitment to the competitive marketplace.

Chairman BAKER. Thank you very much, Mr. Bartlett.

[The prepared statement of Steve Bartlett can be found on page 143 in the appendix.]

Chairman BAKER. Our next witness is Ms. Ann Spragens, senior Vice President and General Counsel for the Alliance of American Insurers. Welcome, Ms. Spragens.

STATEMENT OF ANN W. SPRAGENS, SENIOR VICE PRESIDENT AND GENERAL COUNSEL, ALLIANCE OF AMERICAN INSURERS

Ms. SPRAGENS. Thank you very much, Mr. Chairman, Ranking Member Kanjorski, and members of the subcommittee.

I have served in the current position I hold for 6 years at a National Trade Association representing property and casualty insurers and, consequently, my comments today will be related only to property and casualty insurance, not life and health. Prior to that, I served for 16 years as a regulator in the State of North Carolina, and that combined experience informs my testimony today.

I am going to explain why the Alliance supports State regulation and has since 1922, which was our inception, and also what modernization we view is needed in order to bring State regulation into better alignment with contemporary economic needs of policyholders and insurers. In addition to that, you have also asked me to comment on the adequacy of revenues available to insurance departments to carry out their functions.

First, we support the regulation of property and casualty insurance by the States. P and C products directly reflect the rights and remedies created by each State's law, governing torts, property use and ownership, contracts, domestic relations, corporations law, and a myriad of other subjects. As long as States retain the powers granted to them by the Constitution, this will continue to be the case, and property and casualty products must reflect those differences. As a result, the regulation of the property and casualty industry cannot be carried out without recognizing State-specific law. We believe that States should, therefore, regulate property and casualty insurance as being most familiar with their own laws and their own needs.

We also believe in functional regulation and the usefulness, the continuing usefulness of the McCarran-Ferguson Act. The need for solvency regulation serves policyholders and insurers alike. The financial strength of insurers and confidence in them promotes economic stability for all concerned. There are some who have suggested that modernization of State insurance regulation is really an effort to escape regulation. The Alliance says it is not. It is an effort to align regulatory functions with economic realities of a new century.

The Alliance believes the regulation of property and casualty insurance should concentrate on efficient regulation of solvency with a greater emphasis on market conduct examination and a movement away from the current level of rate and form regulation, especially for commercial lines. Already, 24 States have, in the last 5 years, enacted simplified rate and form filing requirements for commercial lines because they have recognized that it is appropriate to do so and that the marketplace demands it.We believe there is still work to be done to harmonize these changes and obtain them in some jurisdictions that have yet to do so.

It is the need for speed which we believe should drive modernization: Speed to market to provide consumers with product choices, speed in licensing approvals with minimum redundancy, speed in the examination process using practices that focus on sound risk assessment to engage financial strength and a review of market behavior.

Are State insurance regulators adequately funded to carry out that job? We believe they are, to perform functions appropriate to the modern marketplace. However, this may require a realignment of the resources that are available to them and how they are used.

We note that there is budgetary distress in many States across all functions, not just insurance regulation, due to the current drop in revenues from income tax and nonwage income. I think you will see that reflected in The Wall Street Journal today. However, approximately 50 percent of regulatory budgets go to other things beyond conventional insurance regulation, according to a book published in 2000 by the American Enterprise Institute entitled Optional Federal Chartering and Regulation of Insurance Companies, and we will be glad to make these graphs available to the committee.

So States find that they are starting to outsource some of these functions and interestingly, as they tighten their belts, it is the rate and form function that we see being outsourced, a tacit recognition, I believe, that this is the least essential part of insurance regulation and does suggest the possibility of realigning the use of those resources in the fashion that I have described.

Mr. Chairman, this does conclude my oral comments. I offer them together with my written testimony and I hope they will be accepted into the record, and I will be glad to accept any questions from the committee.

Chairman BAKER. Thank you, Ms. Spragens. Yes, your testimony and that of all witnesses today in their entirety will have their testimony included in the record.

[The prepared statement of Ann W. Spragens can be found on page 181 in the appendix.]

Chairman BAKER. Ms. Spragens, I note that you believe, as does Mr. White, that the need for reform is most appropriately pursued at the State level. What are the specific top 2 or 3 things that you think should be achieved in order to facilitate a more efficient market which has not yet been accomplished by the States?

Ms. SPRAGENS. We believe that further reform is needed in connection with rate and form review particularly. This is an area where current economic realities no longer require the same level of agency activity that may have been true in the past. The role of a regulatory agency is not to supplant the decisions of consumers, it is in order to enhance them. We believe that that time has come when rate and form regulation should be loosened on the front end, with market conduct regulation brought at the so-called back end, to assure that consumers are protected.

Chairman BAKER. What about product approval, new product approval?

Ms. SPRAGENS. New product approval comes within that category.

Chairman BAKER. What about the ability to speed up claims processes from a consumer perspective? It is a very difficult morass, sometimes, coming from different State perspectives with multi-State claimants involved. Is there anything that can be done there?

Ms. SPRAGENS. I so much appreciate you asking that question. We recently conducted a survey about 2 years ago gaging the level of consumer confidence in State government's ability to carry out its functions compared to other levels of government, and we found that consumers hold State government in very high esteem in connection with its responsiveness, which is the key point in connection with responding to claims issues.

Chairman BAKER. And Louisiana was in that survey?

Ms. SPRAGENS. All of the States were, sir.

Chairman BAKER. Oh, thank you.

Ms. SPRAGENS. As was Pennsylvania and Illinois and so on. So that in responding to the particular requirements of specific State laws which will control how claims are paid, that is, what is compensable and what is not, State government was deemed to be the best level and venue for that function.

Chairman BAKER. Assuming we would pursue the State level with regard to rate and form, including new products, how long would one want to wait before the Federal Government would act? Is there an agreed upon window? Mr. White may want to get in on this too. Is this a problem that could be resolved in a year or 2, or is this a Gramm-Leach-Bliley problem and we are going to wait a decade? What kind of a clock should we start?

I asked this question last year of the NAIC who appeared before the committee when outlining the goals which they had in mind, and we could never get agreement on even how long the clock should run. Maybe that is where we ought to start.

Ms. SPRAGENS. May I suggest that perhaps a clock is not the way we want to look at it; that what we ought to be doing is gauging the substance of the reforms that are being engaged and brought to bear, because it is functional regulation that is being examined, Mr. Chairman.

Chairman BAKER. Oh, no doubt. I would say that if there was not a substantive reform within some period of time, then the Congress should pursue substantive reforms was my point.

Mr. White.

Mr. WHITE. I think I would agree with that. Your reference to Gramm-Leach-Bliley was very appropriate. However, at the State level, we realize that not every State legislature meets on a regular schedule. Some, as in my State of Arkansas, meet only every other year. So it is important that we give this process time to work through the State legislative efforts. And in our case, Arkansas, we are, in fact, working with our commissioner this year on a package to achieve each of these points that we have discussed: Speed to market, open competition on rates, use and file, as far as new forms, new products; company licensing requirements being made much easier. Each of those issues will be addressed in a package presented by the Arkansas commissioner this year to our legislature. We feel very hopeful, of course, that we will achieve some progress in those areas.

Chairman BAKER. But even if you meet every other year, is this a 4-year problem to be fixed? Is there any outside clock? We are going to agree on something before we finish here.

Mr. WHITE. Well, we might not agree on a time frame.

I would say that there is not a specific limitation. I realize that we must take action. The regulators certainly realize, with congressional oversight, that they must take action, but I would agree with the Alliance, that I think you measure this more clearly by the results, the significance of the efforts, the achievements as they occur and, at some point, if progress is not being made, then it may require a change in direction. But our position is that the State regulators can, with the assistance of the legislatures, can accomplish what it is we need to accomplish.

Chairman BAKER. Well, my time as expired, but I would just make a concluding remark. It would seem appropriate at some point, given the length of discussion that we have already had nationally on these concerns, without identifiable progress being made, there ought to be some point at which the whistle is blown and the Congress begins to debate some of these topics, and I do not know when that point is, but at least we agree on that. I thank you very much.

Mr. Kanjorski.

Mr. KANJORSKI. Thank you very much, Mr. Chairman.

Mr. White, I want to continue along your line of thought. It appears that in Arkansas they are working very diligently, but suppose they are totally successful in everything they do. How is that going to provide uniformity in the 55 jurisdictions that Mr. Bartlett talks about?

Mr. WHITE. Congressman, I believe that we are in a unique position in Arkansas in that our commissioner is currently the Vice President of the NAIC and sees his position as a leader in that organization as an opportunity to take the progress that we can make in Arkansas and carry that across the country during his term, hopefully, as President of the NAIC, working through NCOIL, working through the NCSL, working through ALEC, those organizations that are actively encouraging our State legislatures to react to these —.

Mr. KANJORSKI. What was the term of your president?

Mr. WHITE. Sir?

Mr. KANJORSKI. What was the term of the president?

Mr. WHITE. The term of the president is 1 year.

Mr. KANJORSKI. And in response to Mr. Baker's questions, within a year we should therefore know whether we are going to be successful or not.

Mr. WHITE. Well, that would be nice. In reality, this process, as we all know, began with the adoption by regulators of the statement of intent by the NAIC membership. That occurred in March of 2000, so the process has only just begun. Yes, we are in the second year of that, but I think an evaluation of the progress made on that statement of intent thus far is probably in order. Some of these things, as I mentioned, have been accomplished because of congressional oversight; some because of Federal legislation has required that as a part of Gramm-Leach-Bliley. But producer licensing uniformity has now been passed in 45 States, the most recent I believe being Tennessee. That is something that was required and has been satisfied to this point. That, in itself, was a milestone, because it is the first, after our—several years ago, the response to financial accreditation—.

Mr. KANJORSKI. But that is only about an 80 percent success rate, with 45 States joining out of 55 jurisdictions.

Mr. WHITE. Yes, sir, and I believe the requirement under GOBA was 29 States and the NAIC is very comfortable that they are making progress. We realize there are large States that have not signed on to that process, certainly.

Mr. KANJORSKI. Yes. Mr. White, I am really torn because I think there is a lot of merit to what Ms. Spragens said in regard to States providing a closer response but, on the other hand, but I see the insurance industry having to compete with the banking industry, the securities industry, both of which are national in scope and nationally regulated. On the other hand for the middle to moderate and small insurance company, I think they can continue to do business on a State basis, but I think for the major companies, they are going to be at a decided disadvantage if we do not find some way to clear the field for them. I do not know what that way is, but some way that they can get a product to market very quickly and be competitive with other financial industry participants. And if they are not, they will ultimately be at a grave disadvantage.

Mr. Bartlett, what do you think of potentially having a two-tiered system where we could identify those who would opt in for a national charter because of either their size, the products they write, or the nature of their market being national? Maybe we could identify 10 percent or 20 percent or 25 percent of the market for whom there will be a national charter, and while the second tier group would remain on the State basis.

Mr. BARTLETT. Congressman, we have not examined the specifics of a tiered system, and we would like to do that, to work with you on it. But in general, I think that an optional Federal charter would result by the competitive marketplace in essence, a two-tiered system.

My own view is that most companies would continue to opt for a State charter because they are comfortable with that, they have made it work and they are in one or two or three States. The national companies and many of them, perhaps most, would then opt towards a Federal charter, assuming it is a competitive charter, very similar to what we have in banking. I would caution, I think, the committee against trying to decide in advance which companies get the Federal charter and which companies get the State charters.

I think companies, based on their own market niche and based on the charter themselves, will be able to decide that, but I think it will end up to be the national companies with the Federal charters and the State companies with the State charters. But I think the companies and the marketplace will end up deciding that.

Mr. KANJORSKI. Mr. Bentsen, I thought, made a great point, that we all anticipated in 1999 when we passed the Modernization Act that we were going to have to address this problem of the Federal charter for insurance companies at some point in the future. To jump a little ahead of that idea, should we project how this is going to affect the tort law system of the 50 States? Are we going to be here 10 years from now saying we should have uniform tort laws throughout the United States?

Mr. BARTLETT. That is an excellent question, because that is often sort of thrown up as a straw man. The fact is, as we discovered with the dual-charter system in banking, a Federal charter does not require, nor should it, for the Federal Government to change individual State laws. The Federal charter will—each company would still have to operate within each State law just as they do today and, Mr. Kanjorski, just as they do in every other industry, whether it is banking or steel or coal or home building, they have to comply with the State laws in the States where they operate and still have a Federal charter, so that is perfectly compatible.

Mr. KANJORSKI. Don't they write policies very often using words of art that are crafted by their individual supreme courts so that a policy that uses these words or is interpreted as using these words are understood by the consumer If we take that away from the law as discerned in each of the 50 States and we put it into one uniform contract, how is that going to impact on the legal interpretation?

Mr. BARTLETT. There may be a State in the Union that has a shortage of good layers to interpret Supreme Court cases and write those policies, but I do not know of that State. The fact is that these companies, even under a State-by-State system, every company proposes a product or a form or a policy proposes it for that State and they would continue to do that.

With a Federal charter, however, they could propose a product and bring it to market in a speed to market to all 50 States at once. It is then incumbent, as it is in every other industry, for the company to comply with the laws, both the Federal laws and the laws of the State in which they do business. No difference.

So in short, there is no need to change any or to preempt any State laws with regard to contract law, tort law, or liability laws in any way. Companies should simply be able to have a Federal charter, offer a national product, as they do in every single other industry. This is the only industry that I know of where you are required to go and get permission State by State by State. It makes no sense. Perhaps it made sense in 1945. It makes no sense today. It just simply costs consumers time, convenience and money.

Mr. KANJORSKI. I know my time is running out. Do you have any estimate of what the real cost of this State-by-State regulation is?

Mr. BARTLETT. I do not have an overall estimate. We asked one company, just one company for what they estimated their cost to be, and this was not the largest company by any means, but they are in, I think, 40 States or something like that. They estimated that just the cost of complying with the regulations in filing their forms cost them about $25 million a year of excess cost. Now, that is not the cost of the lost market, that is not the cost of the higher premiums because they cannot serve their consumers, that is just the cost of filling out the forms. That was one company alone.

Mr. KANJORSKI. That $25 million is to how much business written or on what premium? In other words, is it a 2 percent cost, a 3 percent cost?

Mr. BARTLETT. It was about 2 percent of their premiums. About 2 percent cost to their premium holders, and that is not for the cost of the lost market, just for the cost of filling out the forms, basically.

Mr. KANJORSKI. Which would be removed if we had a Federal charter?

Mr. BARTLETT. If that company chose to have a Federal charter. Under an optional Federal charter, just as it is with banking, every company could then decide which is the best for their particular competitive niche, and thus the competitive marketplace would decide, driven by consumers.

Mr. KANJORSKI. Thank you, Mr. Chairman.

Chairman BAKER. Mrs. Biggert.

Mrs. BIGGERT. Thank you, Mr. Chairman.

Ms. Spragens, witnesses at one of our previous subcommittee hearings testified that States like Illinois and South Carolina, and I think that Mr. White mentioned this also where they have allowed the insurance marketplace to work, they have created more innovation and competition and coverage availability. Would you agree with that?

Ms. SPRAGENS. We certainly would, and believe that is an approach that can be very successfully implemented in any State.

Mrs. BIGGERT. Mr. White, would you like to expand on that too?

Mr. WHITE. Yes, ma'am. Obviously, a look at the statistics and the experiment originally, beginning in 1969 in Illinois, gives evidence to the fact that an open market does, in fact, increase competition. The residual market in Illinois, as you mentioned in your opening remarks, is greatly reduced. The choices available to the consumers in your State are much more varied in nature now. The average prices of the insurance premiums fit somewhere in the middle of the country, which would indicate a competitive market, both in products as well as price.

I do not see, and I guess responding in part to your question and in part to some of the comments I have heard, our association, in fact, does represent about 40 percent of the property and casualty premiums written in this country, and we have very many small members in our association, but we also have 5 of the 10 largest writers, and our board of directors as unanimously agreed that States such as Illinois and their regulatory practices are the models that we should attempt to follow in our efforts to modernize.

Mrs. BIGGERT. Do you think that it would make a difference, having an optional Federal charter versus the State regulation to make less regulation, or would there be—do you see it with the Federal that there would be more regulation and it would take away that regulation and competition?

Mr. WHITE. I have, in my experience in this industry, as well as in the industry of public accounting from which I originally came, I have never encountered a situation where the addition of the Federal Government into the process reduces regulation or increases efficiency. In fact, it would appear to me that the initiation of that process itself would add additional costs to the companies involved, in addition to creating potentially an unlevel playing field for the smaller companies that do not elect a Federal charter. Playing by two sets of rules.

Mrs. BIGGERT. Thank you.

Mr. Bartlett, would you agree with that? I guess what I am trying to ask, if you have uniformity and reciprocity when there is no Federal option, but you would still have the regulation, would that be greater or less—.

Mr. BARTLETT. Congresswoman Biggert, the regulatory burden, I have 100 companies who are members, all the large companies, we share many of the same companies, and by 100 companies are unanimous that the regulatory burden, with an optional Federal charter, some of them may not opt for a Federal charter, would be dramatically reduced for a number of reasons: speed to market, the competitive nature of a Federal charter with great deregulation and form deregulation, and just simply a competitive charter as it works in the banking industry.

So there is no disagreement within my companies as to the Federal charter would reduce their costs rather dramatically. Obviously, it is their money, so they have looked at it pretty strongly.

They are also unanimous, by the way, in believing that the Illinois model of rate and form deregulation is the right model for the Federal market. That is modern regulatory standards where you regulate for safety and soundness and for consumer protection, but not on rates and products. So our companies believe strongly that allowing a Federal charter would dramatically decrease costs; not only increase costs, but would decrease costs.

We support uniformity. I mean, we support this drive towards uniformity. It helps. But in the best of cases, the success, if we achieve success and it has not achieved success yet; if it achieves success, success is you convert a grossly inefficient regulatory structure to a merely largely inefficient regulatory structure. You still do not solve speed to market, you still do not provide relief for a national market, and you still do not provide a competitive charter for a company that wants to have a competitive option.

Mrs. BIGGERT. Could you explain just a little bit more a competitive charter, what you mean by that?

Mr. BARTLETT. Well, the best comparison is in the banking industry. J.P. Morgan Chase is one of the largest banks in America, one of my largest members, and they have a State charter, because for a variety of reasons they believe, and it has worked for them, that a State charter works best for them. Most of the other national companies have national charters, so in the banking industry, similar to this, a company could choose which charter is best for their marketplace, their customers, their structure, and then they choose.

Thus, you have a regulatory—the opposite of what we have today, a regulatory drive to excellence, and I will pick on the Chairman's State, where a company based in Louisiana, if they are, for whatever odd reason, they are dissatisfied with the regulatory structure in Louisiana, could choose a Federal charter as an option. I know that is unlikely, Mr. Chairman, but it is always possible.

So a competitive charter then allows the marketplace and ultimately the consumers, through those companies, to choose.

Mrs. BIGGERT. Thank you.

Thank you very much, Mr. Chairman.

Chairman BAKER. Thank you, Mrs. Biggert.

Ms. Hart.

Ms. HART. Thank you, Mr. Chairman.

I kind of have an out of left field question because I was a State Senator for 10 years and I sat on the insurance committee, and through the whole Gramm-Leach-Bliley debate, one of the issues that the NAIC had taken up dealt with keeping the State as a regulator for insurance, but somehow having this model NAIC insurance regulation that all of the States should comply with, which sounds to me like they were looking for everybody to have the same rules, but to have the State still be the enforcer.

I do not know if that is still the case, but I would like to hear your thoughts about that theory, if that is what you are really looking for when you looking to have sort of both levels be involved, but not really, especially those of you who endorse the continuation of the State and really not having a Federal charter?

Ms. SPRAGENS. What the NAIC has been promoting and, frankly, what we support is more harmonization and more uniformity in process. That is different than the great rich variety of State substantive law that I mentioned in my testimony that controls casualty and property products. Money is notoriously fungible and it perhaps can be regulated in a different way. Casualty risks are unique. They vary significantly from State to State. Take, for example, the difference in catastrophe risks posed by weather and geology. That cannot be made, homogenized nationally.

So it is process that can be greatly enhanced, while preserving what is a Federal system blessed by our United States Constitution, and that we believe will continue.

Process can be improved dramatically. This is where there can be uniformity in the speed of turnaround, for example, on whatever filings are required and appropriate within a given State.

Finally, our view is that an optional Federal charter would not be an alternative. It would, in fact, be a second layer of regulation. It would not be more efficient. We believe that proponents would not be satisfied with it if they had it, because it simply is not going to play out that way. The proposals that currently have been floated, of which we are aware contemplate continued activity in State residual markets, for example, which necessarily brings to bear all of the State requirements on what coverage has to be placed in those markets and controlled.

Another aspect of this that is extremely grave from our perspective and why we focus on process uniformity and harmonization is the issue of the level playing field. If very large companies pull out of the State system and take with them their statistical data, this means that the ability to aggregate credible, statistically credible data will be significantly compromised.

This is a unique problem to the property and casualty industry. You will not see this on the life side, for example, or in other industries. That data provides significant confidence for consumers and for insurers alike who are small or midsized to be able to participate in the marketplace in an environment of financial solidity. So we believe all of those issues are crucial and should be examined very carefully in connection with any discussion of an optional charter.

Ms. HART. Thank you. Anybody else on that specific issue?

Mr. BARTLETT. I would. Let me just take the catastrophic risk or the catastrophe risk. The catastrophe risks between Pittsburgh and Cleveland are pretty similar, between New Orleans and Houston are pretty similar, between, pardon me, Congresswoman, between St. Louis and East St. Louis are pretty similar. All other types of industries trade and do business across those State lines with cities that are side by side, and it is only an insurance industry that has to go through these extra steps.The data collection is an easy one to solve. You solve that in the—I do not believe that is insurmountable.

As far as the idea that uniformity in the end can solve the problem, it seems to me in the best of circumstances, 10 years from now, 15 years from now, in a best case, if we achieve full uniformity, that means the uniform, every uniform standard would have to be set by someone, perhaps the then-commissioner of insurance in Arkansas, and sort of jaw-bone to the other States, which strikes me of at least having the possibility of having uniformly bad standards in some cases, because there is no national forum to debate those in a public way, such as the U.S. Congress.

So I think that having more uniformity, more efficiency set by the State-chartered organizations competing with a Federal charter that offers that competitive model is the one in which you end up achieving what is best for the consumers and best for the national marketplace.

Ms. HART. Thank you. I see my time is up. Thank you, Mr. Chairman.

Chairman BAKER. Mr. Ose, you are recognized for 5 minutes.

Mr. OSE. Thank you. Mr. Chairman, if you would clarify something for me. Are issues dealing with the solvency of the insurance companies and the regulatory environment that they live in, are they subject to this hearing?

Chairman BAKER. I am sorry, could you restate?

Mr. OSE. Are issues of solvency and the regulatory environment of insurance companies the subject of this hearing also?

Chairman BAKER. Certainly. This is an informational hearing for the members of the committee and to consider all perspectives of reform where appropriate.

Mr. OSE. I would like to ask Mr. Bartlett about an issue. It is my understanding that in the early 1990s, overseas financial institutions were not allowed to own domestic insurance companies; is that correct?

Mr. BARTLETT. Yeah. I don't know. The overseas companies own domestic companies now.

Mr. OSE. I am aware of that now. But it is my understanding that in the early 1990s that was the case. I am speaking specifically to the issue of Executive Life in California and its purported ownership or control by Credit Lyonnais in France.

Mr. BARTLETT. I was sitting on this committee back then, so I don't know.

Mr. OSE. Does anybody on the panel know the answer to that?

Mr. Chairman, the reason I raise the issue is one of the questions that I think we have to consider in the context of Graham-Leach-Bliley and its implementation is not just the positive impacts of this legislation but also what happens if everything goes south, as it did in California, when a particular company, for whatever reason, was judged to be illiquid or not liquid at all, and was ordered liquidated by the insurance commissioner.

The situation that arose was that there is some evidence to suggest that a company based in France was fronting for Credit Lyonnais, which my understanding is, was statutorily prohibited by law; in other words, another—a foreign financial institution, owned and controlled by arguably the Government of France at some point or another, was in a position to control the prospects for dissolution of a domestic insurance company.

And the reason that is germane is that there are now 300,000 policyholders in California, all of whom had their annuities or coverages given a haircut. And I would hope in the context of our discussion about the implementation of the regulations for Graham-Leach-Bliley, that we would not only look at the positive side but also give consideration to how to avoid a repeat of a cram-down haircut on as many as one, let alone 300,000 people, as happened in California.

With that I yield back.

Chairman BAKER. Thank you, Mr. Ose. That is certainly a subject of importance and we should have rules which construct, as best we can, a method to ensure that no policyholder is left in that circumstance as a result of a corporate failure when the premium payers have done their part. And, it is—I will need to know a great deal more about the matter which you have brought to the committee's attention, But certainly we will investigate that and all similar situations and try to preclude that from recurrence if possible.

Mr. OSE. I appreciate the chairman's offer. I will be happy to share with him the information that I have. It has to do primarily, as I understand it, with whether or not someone can come in, allegedly break the law, be judged to be illiquid, the company is liquidated, and then 8 or 9 years later they pay a nominal fine relative to the appreciated assets that they otherwise controlled.

Chairman BAKER. I assure you that in Louisiana we have someone who is an expert on that subject.

Mr. OSE. I think he is sitting right down there, isn't he?

Chairman BAKER. Thank you. Mr. Ney, did you have questions?

Mr. NEY. Thank you, Mr. Chairman. The question I have is do you believe that a Federal regulator can be as responsive to industry and citizens as a State regulator? I mean we got Lee Covington in Ohio—I wanted to put in a plug for Lee, since I am from Ohio. I used to chair insurance and banking in the State. And we dealt for years with doing our part on the McCarran-Ferguson when different regulations needed to be implemented, and we would respond with each other through the National Conference of Insurance Regulators, et cetera.

I just wonder if a large Federal regulator would be as responsive, and I know you can—States vary differently with people that run the insurance. And I know there is argument of elected versus, you know, people that are appointed and some of the political ramifications of elected process.

But I just wonder in general, anybody, do you have an opinion on the responsiveness of a large Federal regulator? And the reason I state that, if something happened and we went to the Federal side, you know, I just wonder with rules and regulations, some people who would support that would be coming back in about 5 years saying, look what is being done to us; can you please save us from what is going on with the Feds?

Anybody.

Ms. SPRAGENS. Yes. Perhaps the best answer I can give you is that consumers believe that the States are more responsive. And in that regard I would make available to the committee, should you be willing to accept it, a survey that the Alliance of American Insurers did about 3 years ago, I think, comparing consumers' attitudes about the responsiveness of different levels of government to deal with various issues. That question was specifically asked, and that is a response that we obtained that was the result of a Roper-Starch survey on our behalf.

Mr. NEY. Okay. But just to follow up on that, if citizens through surveys believe that—but what about the practical reality of something the Fed creates that becomes the nightmare of the century, and the same citizens come back 5 years from now saying, what is going on, this is all bogged down?

Ms. SPRAGENS. As we have tried to envision how Federal regulation of property and casualty insurers might take place in order to recognize the regional- and State-specific differences that I have outlined, it seems to us that inevitably what occurs is that a proxy for the State system is actually created.

It would be regionalized. There would have to be expertise based upon what is taking place within a particular geographical area. It seems to us, therefore, that it suggests strongly that it would be inefficient to create that layer.

Mr. BARTLETT. Mr. Chairman, let me try—Federal regulatory agencies can be as responsive or more responsive to some States or less responsive to other States, just the way it works in the banking circles. I have, from time to time, some of my members who will talk with me about their dissatisfaction with the State regulatory agency and how they long to be under a Federal regulatory agency in banking, and vice versa. I have it exactly the reverse.

So the marketplace ends up deciding. That is why one of the real advantages in the last 10 years really to the "dual structure," which is what it is called in the industry, is as competitive regulation towards excellence.

So various charters tried to provide better regulation that provides safety and soundness but also is efficient. Now, that only works as long as it is an optional charter, so as long as it is truly optional and a company can choose either one, depending on what State they want to charter in and depending on what the Feds are doing at that time, that is what makes it work is a truly optional charter.

On the subject of McCarran-Ferguson, Mr. Chairman, I must say, Mr. Chairman, I come not to repeal McCarran-Ferguson, but to fulfill it. McCarran-Ferguson, the law itself in 1945 contemplates and provides for legislation such as we are discussing today of an optional Federal charter. In fact, at the core of McCarran-Ferguson it says: provides for an antitrust exemption to allow companies to, as long as they are in a regulated market, to collude on prices on a legal basis.

What this would do is to say in a deregulated price regulation market, you would no longer have the antitrust exemption. And that is the way it should be.

Mr. NEY. Let me put one twist to it, because I have got the yellow light on. Some people would argue that the only way to do this is a Federal charter. But what about not throwing the baby out with the bath water and making some reforms that it is not necessarily a Federal charter but something that revolves around NARAB and how that worked.

Mr. BARTLETT. NARAB is a good step. It is helpful. It doesn't get the job down. It doesn't provide for speed to market. It doesn't provide for competitive marketplace. It doesn't provide for Houston and New Orleans to be able to do business together in the insurance business. It is good so far as it goes. But absent an optional Federal charter, not a required but an optional Federal charter, at the end of the day it can't succeed.

Mr. WHITE. Mr. Ney, also if you allow the concept of the NARAB provision, for instance, that tends to acknowledge that we will, in fact, look to the Federal Government to set the standards and tell the States what they need to do. The discussion of an optional Federal charter—I guess my question would be: Whose option? It seems that the policyholders, the consumer in this case, have been left out of the equation.

The company makes the selection of that option, in fact, because it is better for them. Assuming that is the right choice for their consumer, that may work out just fine. But in the case of a situation in New Jersey, for instance, where New Jersey instituted some extremely stringent regulatory policies, in practice, and almost cleared the State of any insurance market at all, made it extremely difficult on their consumers, at least the repercussions from that decision were confined to the State of New Jersey.

If you had a Federal regulator and that same type of mistake was made, you have just impacted hundreds of thousands, maybe millions of consumers, beyond that one area and it is much more difficult to back-track and fix that problem.

Chairman BAKER. Mr. Shays.

Mr. SHAYS. Thank you, Mr. Chairman. Mr. Chairman, I sometimes think that you get bored in life and need to find controversial issues to kind of just test your intellect.

Chairman BAKER. Thank you very much.

Mr. SHAYS. I also want to say to Mr. Bartlett that as a new Member, I remember your extraordinary activity as a Member of Congress, and I thought that you were the most energetic and effective Member in Congress. And I was very sad to see you choose to leave this place because you were a real model to me and many others.

What would be the alternative to a charter bank—chartered insurance—I am sorry—to having more Federal uniformity? What would be the alternative if you didn't have action from Congress?

Mr. BARTLETT. If there is no action from Congress on an optional Federal charter, then in my opinion, particularly in the property and casualty market, companies would continue to exit. We would continue to have major problems with Europe and other trading partners who object to this as a trading barrier. Consumers would continue to pay some percentage; one estimate of 2 percent higher in premiums.

Mr. SHAYS. So let us assume, though, wouldn't the alternative be for there to be a real effort to get the States to seek to have uniformity?

Mr. BARTLETT. Yes.

Mr. SHAYS. Why isn't that—.

Mr. BARTLETT. Perhaps there could be some success in that. But there are two problems with that; there are several if all you get is uniformity. One is the uniformity has to be imposed by someone, and right now the system of NARAB which has not been adopted by States, representing by my estimate some 30 percent of the premiums, but a uniform standard then would have to be imposed or determined by someone. If that someone is not a national—a Federal regulator, or is not the U.S. Congress, it would be the jawboning effect of the NAIC and whoever is the current chairman.

So in some years you could get excellent standards; in others you can get uniformly bad standards. But the uniform standards, if we ever achieve fully uniform standards, which I don't believe we ever could, they would still be imposed by someone; and the someone would be less transparent then a Federal charter or by the U.S. Congress.

Mr. SHAYS. When I was in the State house, there was this real effort to have uniformity wherever you could. But I was trying to think, is it different industries where there is an incentive for there to be uniformity? Is there any incentive for States to try to build up a uniformity with other States? I can throw that out to Mr. White or to others.

Mr. BARTLETT. Briefly, I think there is. But what there is, is the threat of an optional Federal charter, in my opinion, in that the States are trying to achieve uniformity, and they really are. So I think there is some incentive, but it is the incentive to eliminate the inefficiency.

Mr. WHITE. On that point, I believe we would agree that certainly the State regulators are beginning to feel the heat. When George Nichols, who at the time was president of the NAIC, a commissioner from Kentucky, put forth the principles outlined in the statement of intent, I think that was a reaction to the fact that we do in fact have a system that needs fixing and these are the steps we believe as regulators we should take to fix them.

Mr. SHAYS. I find it rather interesting to think of how we are becoming more and more dependent and interactive with the rest of the world; how they must view coming into the United States, and how they could—I mean, if we had to deal with different regions in France or England or Germany and follow different regulations, I think we would begin to think it was designed purposefully for restrictive practices. So this is something we are encouraging with overseas markets.

Ms. SPRAGENS. But those overseas markets, taking the EU as an example, there are situations where there is not absolute uniformity in all requirements there either.

Mr. SHAYS. That is a good point.

Ms. SPRAGENS. If one reverses the argument, one finds that the same things can be said almost anywhere globally.

Mr. SHAYS. That is a very good point. In other words, we still have to deal with England, we still have to deal with France, as separate entities?

Ms. SPRAGENS. Yes, we do.

Mr. SHAYS. So that argument basically goes out the window. In other words, California and Illinois are different. We can make the same claim that we have the same problem of going to Europe.

Mr. BARTLETT. Congressman, I think that the European Union is particularly tough on that argument. They seem to be, while maybe not winning the political argument, they seem to be winning the intellectual argument in the World Trade Organization and others that this is a trade barrier, and it is thrown up to us with every negotiation that we have with lowering trade barriers in Europe and elsewhere. So it does seem to be—you shouldn't adopt this regulation, this law, just to eliminate the trade barrier. But it comes—it is generally believed to be a real trade barrier in the United States market that does not exist in the European Union.

They are not perfect. They have got a lot of problems, too, but they seem to be ahead of us in this area.

Mr. SHAYS. Bottom line, there could be Federal legislation that establishes a Federal charter. There could be States that decide to link up and have uniformity. And just tell me—my red light is on—but if you could respond to this, what would be the market force that will ultimately push us in one direction, in this direction? What will be the market force that does that?

Mr. BARTLETT. I think for a long time, perhaps forever, you would end up with a dual charter. Some companies would choose the States—.

Mr. SHAYS. No, that is not what I am asking. I am asking—right now, we are kind of in between here, wondering where we are headed. And I am interested to know is there a natural market force that is going to force Congress ultimately to act or force the States to act.

Ms. SPRAGENS. If I may answer that question. One market force that is already at work that has caused 24 States to already revise, say for example, their rate and form filing requirements is the multi-State insured on the commercial side. That is recognized as an important need. States are attempting to respond more quickly. And in addition to that, as has already been mentioned, there is a desire on the part of regulators simply to respond to their constituent needs, including insurers.

Mr. SHAYS. Thank you. Thank you, Mr. Chairman.

Chairman BAKER. Thank you. Mr. Bentsen.

Mr. BENTSEN. Thank you, Mr. Chairman. I apologize for having to leave to meet some constituents.

It is ironic to bring up the European Union. I don't want to go down that path. But we did just have a hearing a couple of weeks ago about their proposed financial services regulations and the idea of having a regulator of a consolidated entity, and whether or not our insurance regulatory structure would run afoul of that to the extent that you had U.S. Insurance companies that wanted to do business within the Euro zone area. But I don't want to get—I don't know that that is an issue, in and of itself, of whether or not you ought to have a Federal charter.

But it does strike me as surprising, still, that the industry has not come to the conclusion that a dual charter is not such a bad thing. And I will use as an example the securities industry. There is a dual regulatory system where the SEC is responsible for regulating the national market function; the States are responsible really for consumer, individual consumer regulation.

Now, one could say, well, look at the current situation with securities and the research analyst situation, and perhaps the SEC was slow to fulfill its role. But arguably—and I know the chairman has raised some concerns about this—the States, in this case the State of New York, has actually—the State regulator has actually fulfilled its role.

Why is it that we couldn't have a similar situation by having a dual charter system for the insurance industry? I don't think anyone is talking about changing the solvency to having a Federal regulator for solvency purposes. I think it is the idea of how you have a national market regulator for what is—particularly in the case of life insurance, because it is an investment product, is becoming—is a national marketplace.

And I would also add—I mean, this is an issue that is problematic in my State on the P&C side, which arguably is a completely different product. But how do you deal with the companies that are pulling out? We have a problem with mold in Texas, with wind storm coverage in Texas. And so I am not sure that we haven't finally come to the conclusion that we need to have a dual national charter. I still don't understand why there is this concern about it.

And why we can't have—I mean, we have blue sky laws that affect the securities industry. And States are still allowed to set requirements for registration, still allowed to set requirements for who can sell what types of securities, and yet we have a national marketplace. Why can't we do the same with insurance?

Ms. SPRAGENS. That is an abundance of riches of questions. I am certain I won't respond to all of them, but let me try. First of all, the Alliance and our member companies do not support a dual charter because we do not believe that it will deliver the efficiencies that are hoped for. We are very quick to say that more efficiency is needed, but we don't believe that will actually produce it. In terms of comparisons with regulators from other industries, they are different industries.

The national marketplace for the capital markets does make sense perhaps to regulate at a Federal level. Casualty risks, however, are very local in their character. There is no true property casualty national product that does not have to be tailored to local circumstances based upon State law and particular geological and geographical requirements, for starters.

Mr. BARTLETT. Congressman, in the industry, at least as I define it, which is the large integrated companies—those that have other options of other things that they can and are doing in the financial services marketplace—it is unanimous. It is unanimous. It has been unanimous for several years. Those companies that are members of mine. Some are more vocal than others. Unfortunately, some are not vocal out of a misplaced fear of retribution by State commissioners. I think that is misplaced. But some don't believe it is misplaced, so they are not as vocal or as forthcoming.

But among those companies that are large and integrated and national, there is zero debate about whether or not an optional Federal charter will help the American consumer and provide a much more rational marketplace. And the only disagreement is how vocal that they choose to be individually.

Mr. BENTSEN. Well, I would just say—go ahead.

Mr. WHITE. I would, I guess, question the analysis of that, only in the sense that we are attempting to compare the cost of a dual regulatory system with the cost of the present system. And yet we don't know the details of what that dual regulatory system may bring: the layers of additional bureaucracy that may be required, the regional offices, the people that are closer to the consumer. And it would appear to me that even if we had, in a perfect world, the ideal piece of legislation that could create a dual charter situation and give us an option, we absolutely have no belief that perfect piece of legislation is what we are going to end up with when it comes out at the end. I think we are dealing with an unknown in that regard.

Mr. BENTSEN. Thank you.

Chairman BAKER. Thank you. I just want to make sure the record is accurate, Mr. White. In your response to a question from Ms. Biggert about preferred structure of markets, I think you indicated that the Illinois plan was something you found to be—model—was one you found to be desirable, and that consumers were well served because there was more competition and better prices in the market as a result of that type of system. Is that accurate?

Mr. WHITE. Yes, sir, that is accurate.

Chairman BAKER. Is there any reason why that model wouldn't be good nationally?

Mr. WHITE. I don't believe there is a reason. I don't know all of the details within the Illinois system. But the concepts that are in place there certainly are concepts that would work in other property and casualty markets.

Chairman BAKER. We found something we can agree on. Thank you very much. Does any other member have—Mr. Bentsen.

Mr. BENTSEN. I have two points. But one is, Mr. Bartlett, just to get some clarification up front if this question were ever to be asked, because Ms. Spragens sort of segments out the P&C industry—presumably the Financial Services Roundtable would want a Federal charter, a broad Federal charter—you don't want to subdivide the industry between life, life and investment or versus—.

Mr. BARTLETT. Right. P&C and life. Yes, sir.

Mr. BENTSEN. Ms. Spragens, I do agree that there is certainly a State nature to the P&C industry, but I will remind you that subsequent to September 11th, the P&C industry was in Washington, hat in hand, with a very good case about the need for a federally structured backstop for P&C.

And we have looked at other issues. In fact, I have been a sponsor and cosponsor in the past of Federal reinsurance market for P&C for national disaster. So it does sort of cut both ways.

Ms. SPRAGENS. May I respond?

Mr. BENTSEN. Sure.

Ms. SPRAGENS. We believe that terrorism is not an insurable risk. We paid it out of good faith and concern for our policyholders. We are in the business of paying claims, and we want to. Nonetheless, the lesson of 9/11 is that terrorism is not rational in the sense that casualty risks insured by the property casualty industry can be rationalized. As a result, we do not believe that it is insurable. And that is the reason that we came here.

Mr. BENTSEN. I don't disagree with you because, as I said, I agreed with parts of your industry when it came to the question of national disaster risk, as well, and whether or not there was a sufficient reinsurance market. So I do think there are some Federal roles here.

Thank you, Mr. Chairman.

Chairman BAKER. Thank you. If no other member has any further comment, I want to thank the panelists for their participation. We found your testimony to be of value. We do appreciate it. Thank you very much.

Chairman BAKER. I would like to ask our second panel to come forward. Okay. I would like to welcome each of you to the committee's hearing this afternoon. We appreciate your willingness to participate.

Our first witness is the Honorable Mark Young, State Representative from Vermont, who appears here today on behalf of the National Conference of Insurance Legislators. Welcome, Representative Young.

STATEMENT OF HON. MARK YOUNG, VERMONT STATE REPRESENTATIVE, ON BEHALF OF THE NATIONAL CONFERENCE OF INSURANCE REGULATORS

Mr. YOUNG. Thank you, Mr. Chairman, members of the subcommittee, thank you for inviting the National Conference of Insurance Legislators, or NCOIL, to testify before you today. I am Representative Mark Young, and it is my privilege to represent residents of Addison and Rutland Counties in the State of Vermont legislature. It is my further privilege to serve as Vice Chair of the NCOIL State-Federal Relations Committee.

NCOIL welcomes your request for testimony on State insurance guaranty funds and residual markets. The guaranty funds provide an example of how well State insurance regulation can work. In fact, it may be worth noting here that none of the present-day critics of State insurance regulation have identified the State guaranty fund system as being inefficient, ineffective, or in need of major reform.

I will first provide some basic details on State guaranty funds and their purpose. Then I will move on to discuss how the funds have fulfilled that purpose.

In each State a guaranty fund consists of insurers doing business in that State in a particular line of business covered by the fund.

State insurance guaranty funds make good on the outstanding insurance obligation of insolvent insurers. At the point where the assets of an insolvent insurer are insufficient to meet claims obligations, the guaranty funds pay the balances up to limits set by State statute. The funding of those payments comes from the assessments of the remaining insurers, which range from 1 to 2 percent of premium volume, but are also pro rata to the State market share and the lines of business in which the insolvent insurers had engaged.

Each State has its own guaranty fund laws for life and health insurance and for property and casualty insurance. Some States have additional guaranty funds set up for workers' compensation and surplus lines insurance. These State laws conform substantially to the model laws adopted by the National Association of Insurance Commissioners.

All States post-assess insurers to cover insolvent insurance claims, except the State of New York which pre-assesses its property and casualty guaranty fund up to $200 million. The insurers licensed in the State constitute the guaranty fund in that State under the supervision of a board of directors and, ultimately, the State's insurance commissioner. The State guaranty funds coordinate their work, especially with regard to multi-State insolvencies, through two national organizations: the National Organization of Life and Health Insurance Guaranty Association, and the National Conference of Insurance Guaranty Funds.

Guaranty funds serve as an effective and efficient backstop to safeguard consumer interests in cases of insolvency. The funds have assured continuance of coverage to policyholders of insolvent insurers; paid more than $14 billion in the last 25 years to policyholders; they have grown in financial capacity, and done so at no direct cost to State or Federal taxpayers; and have shown that guaranty funds work and do not need to be fixed in any significant way.

The funds have been there when needed. The property casualty fund system has stood the test of Hurricane Andrew, which felled several insurers, as well as many other insolvencies caused by increases in the costs and severity of medical malpractice claims and the expansion of toxic and environmental tort liabilities.

The guaranty fund system was sufficient when Mission Insurance Group became insolvent in 1985, resulting in 700 million in State guaranty fund payments, the largest amount for a single insurer in history.

The system worked during the next 4 years when five more national insurers were placed in liquidation, resulting in State guaranty fund payments of an additional 1.9 billion in claims.

On the life and health side, the guaranty system effectively met the challenge of the early 1990s, when the live insolvency activity reached its peak. In 1991 alone, there were 23 new insolvency cases on the life side. One of these cases, Executive Life, involved in excess of 10 billion in policy obligations. The guaranty associations effectively protected Executive Life policyholders by transferring their covered policy obligations to a third party insurer. While the guaranty associations are still making payments to the assuming insurer on behalf of Executive Life policyholders, it is estimated that the total guaranty association costs will be about 2.5 billion on a net present value basis.

State guaranty funds operate and pay claims at no direct cost to State treasury or taxpayers. The policyholders of all insurers ultimately bear the costs as a part of their premium payments.

I might really go into and explain residual markets. States have also established many different residual market programs to make available insurance to individuals and businesses having difficulty obtaining coverage where the normal market has ceased to function effectively. Residual markets are important for high risk applicants or individuals and businesses with poor loss records.

Residual market insurance premiums are set at a lower level than they would be if they were established on a strictly actuarial basis. Therefore, coverage is attainable for everyone who wants or needs insurance. Profits and losses of each residual market program are shared by all of the insured in States selling a specific type of insurance. Residual market programs are rarely self-sufficient and generally require assessments to insurers, which are ultimately passed on to all insurance consumers.

Against this backdrop, the idea of a separate and competing Federal guaranty system of insurers operating under a Federal charter, such as those proposed in Congress by Senator Schumer and Representative LaFalce, could not help but weaken the State-based system. It would weaken the strong State consumer safety net, deplete its capacity from 4.8 billion to less than 3 billion, and reduce its overall risk pools. It would build another layer of overhead, create duplication in process, and add unnecessary expense.

We believe this system has worked well and is no way broken. Congress, I respectfully submit, does not need to fix it, replace it, or establish anything parallel to it.

While guaranty funds and residual pools stand well today, we believe continued oversight is absolutely essential to the continuance of their effective function. We submit that an interstate compact idea is one that is available if needed. But for now, the guaranty fund system does not require the focus of Congress, although your constructive oversight is welcomed and appreciated.

I thank you for the opportunity to provide this testimony. My written submission is far more detailed than the time would allow me to address orally. And, Chairman Baker, I would ask, given the short notice of this hearing, that the formal record be held open so that I might submit final comments. I thank you.

[The prepared statement of Hon. Mark Young can be found on page 214 in the appendix.]

Chairman BAKER. Thank you, Representative Young. I would make the announcement that for all purposes, for all members as well as all witnesses, the record will be held open for an additional 30 days for any final comments that anyone might choose to offer after the hearing is adjourned. Thank you, Representative.

Chairman BAKER. Our next witness is Mr. Michael D. Phillipus; is that correct, sir?

Mr. PHILLIPUS. That is correct.

Chairman BAKER. Vice President of Communications and External Affairs, Risk and Insurance Management Society. Welcome, Mr. Phillipus.

STATEMENT OF MICHAEL D. PHILLIPUS, VICE PRESIDENT OF COMMUNICATIONS AND EXTERNAL AFFAIRS, RISK AND INSURANCE MANAGEMENT SOCIETY

Mr. PHILLIPUS. Thank you. Good afternoon, Chairman Baker, Congressman Kanjorski, and members of the subcommittee. My name is Michael Phillipus. I am Vice President of External Affairs and Communications for RIMS, the Risk and Insurance Management Society, the largest professional organization in the risk management community. I appreciate the opportunity to appear before you today on the issue of insurance regulation and competition in the 21st century.

RIMS member companies, which comprise over 4,000 consumers of commercial insurance, support the advancement of efficient insurance purchasing abilities. RIMS membership includes 84 percent of the Fortune 500 companies, as well as approximately 950 companies with less than 500 employees.

I would first like to spend a few minutes on several issues that the committee had asked me to address: specifically, alternative insurance markets and surplus lines.

The job of a risk manager is to protect and preserve physical, financial, and human resources. One of the primary means of accomplishing this job is through the purchase of insurance. The first hard market of the 21st century has made this job even more difficult, and risk managers are forced to be more creative in minimizing risk to their organization and their employers. More and more often, risk managers are turning to alternative markets to procure necessary coverage.

Captive insurance companies are an important part of the alternative insurance market. Captives are closely held insurance companies whose insurance business is primarily supplied and controlled by its owners, who are also the principal beneficiaries.

The advantages for establishing captive insurance companies include reduced operating costs, flexible coverage, direct access to reinsurance, some assurance of stability of premiums and coverage terms. Risk retention groups are a form of captive insurance companies. These groups provide certain insured with casualty protection on a homogeneous basis that removes their risk from volatile industry cycles and provides focused service customized to their exposures. Authorized by Federal law, they are incorporated under State law and governed by the law of the State of domicile.

The Liability Risk Retention Act, or the LRRA, passed in 1996 does not permit risk retention groups to underwrite property insurance. This limitation reduces the number of insurers that can underwrite property insurance at a time when market restrictions from terrorism threats, combined with the hard market, have driven prices up and reduced availability. RIMS urges Congress to expand the LRRA to permit risk retention groups and risk purchasing groups to write all coverages except personal lines and direct statutory workers' comp coverage.

In order to adequately ensure unique, difficult to place, or high-capacity insurance risk, risk managers frequently use the surplus lines, or sometime called the excess lines market. Rather than an alternative market, the surplus lines market is better described as a supplemental market to the licensed/ admitted market. The surplus lines market, in effect, serves as an outlet or a safety valve market to be utilized by risk managers and their brokers when the desired coverage cannot be found among the States admitted/licensed insurers, or when market forces or conditions in the admitted/licensed market causes voids and gaps to occur in coverage for certain types of risk.

Freedom of rate and form is essential for the surplus lines market to have the flexibility to quickly and adequately respond to the risk manager's insurance needs, particularly for hard to place, distressed, unique, or high-capacity limits.

I would now like to discuss RIMS' position on insurance modernization, specifically optional Federal insurance charter. RIMS recognizes both the incredible promise and the inherent hazards of an optional Federal insurance charter. The Society appreciates the serious and complex implications of allowing insurers to obtain a federal license that would allow them to operate nationwide. The current system in the United States is inefficient.

Negotiating rate and form regulations in more than 50 jurisdictions is expensive and time consuming. A single regulator, to establish risk-based capital and surplus requirements as well as requirements for public disclosure of rates and forms, would reduce costs and restrictions for U.S. Purchasers and act as an incentive for increased participation by foreign companies.

The State regulation system needs to remain accessible to those insurers who choose not to participate in the Federal option. Ideally an optional Federal charter would spur improvement and innovation at the State level. The NAIC has taken measurable steps to reform State insurance regulation, most notably the adoption of the State certification program, speed-to-market initiatives, and steps to deregulate commercial lines of insurance.

By the very nature of State regulation, however, it is almost impossible to achieve uniform laws and regulatory interpretation of those laws. Nevertheless, creation of an optional Federal charter should involve the NAIC on a consultative basis to ensure that States' rights and revenue issues are properly addressed.

RIMS understands that it may be a long road to approve an optional Federal charter legislation, but we believe that the time for this idea to become reality is now.

In the end, all of those risk financial options are crucial to risk managers, but there is no one-size-fits-all solution for insurance commercial consumers. While the alternatives discussed today provide some relief, RIMS ultimately favors a system unfettered by overreaching regulation, one that has the ability to add flexibility to respond to the various needs of the consumer and the changing marketplace. Certainly small and mid-sized companies benefit from the oversight protection provided by the State insurance regulation system. Care must be taken that this system does not restrict the movement of product and the ability of consumers to attain adequate and affordable coverage.

Thank you for the opportunity to speak today. I appreciate your time, your interest, and your leadership.

Chairman BAKER. Thank you, Mr. Phillipus.

[The prepared statement of Michael D. Phillipus can be found on page 165 in the appendix.]

Chairman BAKER. Our next witness is Mr. Steven Harter, President, National Association of Professional Insurance Agents. Welcome, sir.

STATEMENT OF STEVEN J. HARTER, PRESIDENT, NATIONAL ASSOCIATION OF PROFESSIONAL INSURANCE AGENTS

Mr. HARTER. Thank you. Mr. Chairman, members of the committee, my name is Steve Harter. I am the owner, chief principal, for Select Risk Management in Ava, Missouri. I also have the honor of serving as the current President of the National Association of Professional Insurance Agents. We are a trade association representing independent insurance agents and their employees in all 50 States and Puerto Rico.

Mr. Chairman, as you have asked us to do, PAI will outline some of the key competitive issues faced by multi-State insurance producer operations, including the issues regarding countersignature laws.

PIA is absolutely committed to a reform of the insurance producer system in a manner that means effective oversight for public protection. The progress that has been made with the new single NAIC Single-License Producer Model Act has been wonderful, but it hasn't yet been adopted in all jurisdictions. In addition to these States, there are also challenges in some of the States that have designated themselves as NARAB compliant by virtue of reciprocity only.

Collectively, these minority jurisdictions still pose challenges in the following areas:

First of all, countersignature laws. Since 1970 PIA has worked to repeal countersignature laws as well as the secondary level of insurance statutes that, while not technically called or classified as countersignature laws, in effect act in concert to frustrate open nonresident participation.

Much progress has been made in the repeal of the countersignature laws, and only a few remain. PIA appreciates and is sensitive to the unique market and public policy circumstances that exist in Florida and Nevada, but believes their issues can be solved without countersignature laws.

However, less progress has been made on the secondary level of statutes that act in concert with countersignature laws. In some States the per se countersignature law was repealed but the companion statutes were not.

As an example, many times the case, if I have a commercial client who secures a business operation in another State, under countersignature laws I am forced to secure the services of a resident countersigning agent from that State that my client will not know and whom I might not know either. This resident agent must already be licensed in this State to write the specific type of coverages for my client's new operation in that State, as well as already be appointed by the carrier with which all other aspects of their coverages have been placed. As the principal producer on the full account, I must still be sure that all forms and the carriers are authorized to write and issue the type of coverage being secured. The in-State agent would then technically place the business by merely countersigning the policy form and collecting a fee for services.

Under a State with secondary statutes, I might be able to perform all the regular tasks and issuance of coverage for any client; however, the State might require that I deliver a copy of the policy for the business location through the services of an in-State resident agent operating in the county where the business is located.

Another issue is the single-license producer versus the agent broker license. A number of jurisdictions have yet to adopt a single-license format. The nature of our business requires that we perform both functions for clients' insurance needs. Thus, in these States we are required to secure both agent and broker licenses as resident producers. As nonresidents we must select one or the other, thus limiting the type of activities to be performed for our client in that State.

Yet another issue is the agent-only jurisdictions. These jurisdictions do not recognize the broker's status, something fundamentally required for our clients' needs, whether on a resident or non-resident basis. If in my resident State I am licensed under the single-license producer approach, and by nature of my business operations I am acting in a broker capacity, I am forced to change into an agent for nonresident purposes in the jurisdiction, something that may or may not be possible or even wanted.

Another issue is the individual versus the business entity. Today, several States only make available an individual producer license. In these jurisdictions, PIA members operating in a business entity basis are forced to only have one of their individually licensed staff members file as a nonresident in those States. This creates numerous legal, insurance appointment and tax problems for such agencies, and, in PAI's opinion, lessens the comprehensiveness of the State's oversight of the insurance operation.

We also have an issue regarding foreign corporation filings. This is an example of noninsurance government officials applying a one-size-fits-all solution. In simple terms, persons operating in what would be considered a nonresident status must first file for and secure foreign corporation licenses permitting them to enter the State.

Insurance departments have over 150 years' experience with the structure, authority, and expertise required for this issue. PIA wants insurance producers relieved of this additional foreign corporation filing. It is duplicative of the nonresident licensing process.

Background checks: This committee's efforts related to the passage of H.R. 1408 are much appreciated by PIA and its members. Prior to its passage, PIA's board adopted a position last September, making it clear that we support H.R. 1408 as the preferred process along with the one-time electronic fingerprinting of all individuals currently licensed as well as anyone applying for a license in their resident State. Is This process should be recognized on a reciprocal basis for nonresident filings as well.

In conclusion, PIA is working on a Federal proposal addressing the concerns we outlined today, the details of which will be discussed in a future hearing by our partners at the IIABA.

We believe this proposal acts to refine and improve on Graham-Leach-Bliley, NARAB, and supports NAIC's current additional reform efforts. PIA's charge from its members is to participate in and ensure that all four areas of reform activity—model laws, State-by-State reforms, multi-State compacts, and additional Federal proposals—come together in a single coordinated and complementary system.

Accordingly, PIA opposes Federal optional charter proposals because at their core they are designed and operated as an additional competing insurance system. Neither our customers nor our members need a 56th insurance jurisdiction.

Again, I would like to thank you for allowing PIA to testify before this committee on this important issue.

Chairman BAKER. Thank you, Ms. Harter.

[The prepared statement of Steven J. Harter can be found on page 153 in the appendix.]

Chairman BAKER. After listening to your list of the conflicting requirements for the licensed agents, it would seem hard to comprehend that there wouldn't be fairly significant support for some sort of national licensure purposes, just to simplify the list which you have elucidated for the committee today. It is mind-boggling enough.

Mr. HARTER. You ought to be on this end of it.

Chairman BAKER. In the earlier panel, there was some discussion about the Illinois model which, as I understand it, is an open, competitive system allowing—as described by one of the advocates of the system—allowing competition, providing consumer choice at pretty good price. It is not a prior approval State. There are no speed-to-market issues. Do you see the Illinois model as a model which has advantages from an agent perspective?

Mr. HARTER. I think any State that speeds the process—I think the Illinois model is user-friendly from an insurance agent's perspective. Many States are going in that direction.

Chairman BAKER. Representative Young, I understand the concerns from a State perspective about a Federal intervention unnecessarily into the conduct of its business. But at some point there has to be an acknowledgment that if there is not State-by-State action, then demands of the marketplace will require that the Feds do something.

I don't take from your comments that there is—and frankly from any witness's—that anybody feels that speed-to-market issues are insignificant; that creating uniformity in agent licensing isn't appropriate; that making market conduct examinations relatively uniform in application, eliminating arbitrary price fixings and allowing competition in the marketplace to govern the price and the product—if those were the issues around which we had principal concern, what is a reasonable clock?

If we were to in good faith, say in an NARAB on steroids, States of the world get out there, get it done by—what is a reasonable clock in your view?

Mr. YOUNG. Well, I think my understanding is that the NARAB idea or suggestion, many of the States have already adopted those measures, and I believe 18 months in advance of the deadline.

I realize all States have not done that. The earlier panel spoke about legislatures that only meet every 2 years or that type of thing. But I do not see it being a long, drawn out affair to put a time limit on it. I do not. Four years, possibly, something of that nature.

Chairman BAKER. So if we could as—the committee is going to have additional hearings. As a matter of fact, the next hearing is going to be dealing with some of the international issues that were raised in the earlier panel. It is going to be a broad series of hearings over the course of the summer. But at end of it, I think there are going to be a number of issues on which there is pretty much clear agreement, and there are going to be a handful of issues on which there is going to be some contentious decisions to be made. If that is the way in which this develops and we resolve to let the

States act within a certain time frame, they being unable to act whatever that time frame is, then we have to act.

As you point out, NARAB has been partially successful. But some of the numbers don't speak really to the operational compliance. Merely adopting a reciprocity agreement doesn't get uniformity. If you both agree to have a countersignatory requirement, that is not moving in the right direction.

Is it pretty much the agreement of the panel that those general issues that I have outlined are areas where we could make some progress on the question of whether or not it happens State by State or whether it has to be done by Federal intervention is the issue?

Mr. Phillipus.

Mr. PHILLIPUS. I do agree that there has been improvement on the State side. And as I indicated in my testimony, RIMS is supportive of NAIC's continuing efforts. However, we do think that the optional Federal charter gives additional latitude to insurance consumers. And in the case of the RIMS members particularly, those are large corporations which have sophisticated risk management departments in management of financial issues, and they are looking for quite often rapid answers to problems that they face.

We have seen over the last few years the advent of issues such as the Y2K employment practices, liability, e-risks. And these are things which generally have come up rather quickly. And generally the marketplace has responded from the surplus line side or outside of the United States as opposed to within-State basis, and they have been generally innovative in their approach.

And those are the type of creative solutions that risk managers and their member companies are looking for.

Chairman BAKER. Thank you, sir. Mr. Kanjorski.

Mr. KANJORSKI. Mr. Young, as I gather, your argument is that States can best supervise and handle the regulatory process, safety and soundness oversight, and all of the other issues regarding insurance at this point. Is that correct?

Mr. YOUNG. That is correct, sir.

Mr. KANJORSKI. If that is the case, then why is there federal pressure here in Washington and on the Hill for us to enact a terrorist reinsurance support system for the insurance companies? Why don't the individual States just do that?

Mr. YOUNG. I think that issue is larger than what the States can deal with on their own. The previous speaker had mentioned that terrorism probably is not an insurable risk for an insurance company, certainly not an insurance company sitting here as a legislator. But that huge impact is not an insurable risk or a predictable risk and really surmounts the capacities of the States to individually deal with it.

Mr. KANJORSKI. Well, if the States are going to regulate and we are going to do the reinsurance and the bailing out, what kind of protections do the American taxpayers generally have from the acts of Congress to benefit the ability to underwrite certain risks?

Mr. YOUNG. Well, I still say it is a risk that rises about the normal insurance market and is too large for the normal insurance market to take in stride, or could be. They certainly have paid claims for September 11th, but it is foreseeable that it could happen that they could not stand to cover those claims.

Mr. KANJORSKI. I understand that. I have been a supporter of the Federal terrorism reinsurance support system. But if the States can handle all of these things, why shouldn't we just pass a law apportioning out to the States what the reinsurance should be, what their support requirements would be, and let them go ahead and handle it? I see sort of an inconsistency here for us to say that this is able to be and is being well handled on he State level and yet, quote, there are times or needs when we have to come to the Federal Government, unquote.

And this is not the first time. In health insurance, vaccination insurance, and other support systems, the Federal Government has had to step up, and I think rightly so. I am not condemning the States. I think it is beyond their capacity to handle some problems. And it seems to me if that is the case, there seems to be a very strong case at least for the potential of an optional Federal charter.

Mr. YOUNG. I think from my comments that the guaranty fund has worked so well, that certain size claims can certainly be covered by assessment on a State-by-State level. I think there is a point by which we exceed the capacity of the assessment system to cover those losses.

Mr. KANJORSKI. Are these products and regions so unique that if we allow some companies to get an optional Federal charter, we are eviscerating some protection for consumers or the uniqueness of the State or region in which the company is involved?

Mr. YOUNG. I don't think so. But I will say that the guaranty fund now works quite well for companies that are regulated in another jurisdiction—in another State. They are formed in another State, and they work well regardless of where the loss is.

Mr. KANJORSKI. In a prior life that I lived as an attorney, I had some experience with performance bond insurance. And there were some States that had a regular habit of having their insurance companies underperform and declare bankruptcy when any substantial claims were made. As a matter of fact, I used to recommend to some of my clients not to purchase a surety bond if it came from a particular State.

Is it not rather difficult for businesses and for lawyers and for everyone else to know what the solvency standards is for an insurer, or the particular criteria in the various States with which we are dealing? Whereas, if we had a national charter, there would be one regulator, there would be one safety and soundness standard, and a calmness of certainty would exist across the States as to what companies were solvent and what companies were unsolvent?

Mr. YOUNG. I think it is imperative and I think its function is that we trust other States to regulate their insurance companies. And through the accreditation process that has been formed, we know that insurance commissioners and departments across the country are adequately supervising the insured that are within those States.

Mr. KANJORSKI. At one time we did that for prescription drugs in this country. We did not have the Federal Drug Administration. I guess we could go back and allow each State to handle that type of regulatory question, but would that not be awfully redundant and expensive for drug companies to have to qualify in each State and meet the particular conditions that each State would want to lay down? Whereas, if you had one Federal process, it allows for speed-to-market for product, and it allows for less risk to the consumer.

Mr. YOUNG. I really don't know if I am qualified to answer that.

Mr. KANJORSKI. Well, it is interesting. On your point on representing the companies and brokers and sales operations, is there a fear within the organization that in going to an optional Federal charter that your members will be more at risk? If so, what would the risk be?

Mr. HARTER. I think the risk is having another jurisdiction. You wind up with 56 jurisdictions instead of the 55 that you have now. The industry, the agent broker industry, has been very resilient. They have been able to respond to working with the various different State departments, and we feel that those departments are effective. They are very responsive to the individual States and the consumer laws, et cetera, in the States where they operate, and we see the systems being complementary as working with each other as being the answer to it, not replacing one with another.

Mr. KANJORSKI. Well, why couldn't you, because it is 56 jurisdictions, not one jurisdiction? Is that the major problem, that we would have a 2 percent increase in jurisdictions involved, that we should deny the national companies the ability to save the 2 percent that Mr. Bartlett talked about in costy?

Mr. HARTER. I do not know how to respond to the 2 percent because that is not a number that I am familiar with. But I do not know whether that is accurate or not, but it is not necessary. The system as it stands, by working with a set, a uniform set of standards being managed, if you would, by the States, the individual insurance departments, I think you can solve the issues.

Chairman BAKER. Thank you, Mr. Kanjorski.

Mr. Shays.

Mr. SHAYS. Mr. Chairman, I get a lot of constituents who come to my office and want there to be a Federal solution to whatever particular problem; they just see it much more simply done if there was just this one policy.

I think this is a fascinating debate, having served at the State level, because sometimes the argument to cut costs and to go on a Federal level could be made almost in every conceivable industry. So I am trying to get a handle on ultimately what is the right way to approach this. Is this a State responsibility, and therefore should the States just be the ones to deal with it, or is it a Federal one?

I guess what I would want to ask the panel would be this question: Is there a clear benefit of reductions in cost by having a one-size-fits-all opportunity? Will there be more competition as a result of it? Will the consumers see lower prices? Is that the bottom line argument on one side versus the other argument, that if you have State-level activity, that you will have, in some cases, better protection for the consumer?

I know for instance when we went to regional banking, all of our banks went under. Maybe they should have been nationalized. But I mean, not nationalized, but maybe they should have, when we lost our banks, maybe it should have been that they should have gone just beyond the New England region.

I would just like the panelists to address the issue of cost versus the issue of doing something on a smaller scale means that you don't have everybody negatively impacted if you face bad times.

Mr. YOUNG. I guess I would have to tip my hand here a bit. I sit here this afternoon as the President and CEO of a national bank, and from everybody's comments this afternoon, I have been kind of incredulous that I have it so good on the regulatory front. My regulators are in Boston. In asking questions of regulators, it takes a length of time, if ever, to get a response from my regulator. My customers on the bottom of their forms are told if they have a consumer complaint to call Washington, and I do not think they are responded to as well as if it was a local or State insurance matter.

Quite frankly, if I did not have probably the sixth or the eighth oldest charter in the United States, I would have gone to a State-chartered system a long time ago in that I would have contact with my regulator in a much better case.

So I think, I really do believe, that in a dual chartering situation, the consumer is not as well served as by State regulation.

Mr. PHILLIPUS. Congressman, I think some of the points that Ms. Harter brought up are some of the concerns that our members have. The idea of having to have a document shipped across the country for a signature from someone who had not participated in the process, just because it is required, ultimately increases the cost to our members, the consumers, the ultimate buyers of insurance.

Likewise, for example, as risk managers one of the common complaints I hear is an issue regarding something as simple as automobile insurance, and the fact that if you decide to take a lot of risk yourself as a company, you have to fill out countless forms for uninsured motorists, personal injury protection, and medical payments to reject them. Every State has a different form, sometimes requiring up to six different signatures, sometimes three different forms; and there are costs associated with it when the insurer has to provide those stacks—which can be this thick—for some of our members to the risk manager. And then the time has to be spent by the agent, the broker, and the risk manager to review the documents, make sure they are correct, and then they get sent back. Ultimately, all you are doing is saying we want to accept the risk ourselves.

So from a consumer standpoint, we see that as a waste, we see that as inefficiency, and we see that there are opportunities to reduce costs, to improve the system, and we think that the optional Federal charter would provide that opportunity.

Mr. HARTER. I do not think the Federal charter is the answer to it at all, in responding to what Mr. Phillipus has said. Many of the States have laws, no fault laws, you have many different laws that these uninsured motorist forms are responding to. I am not sure that is the intent of the optional Federal charter, to do away with that.

You also have situations where the national companies certainly do not intend to be all things to all people in these States. You are still going to have situations where I as a broker and as an agent am dealing with a customer that maybe has a federally chartered policy, they have a local State-chartered policy, and I do not have any idea how all of that is going to come together. All I can foresee right now is it is going to be an incredible problem that we probably do not have to get into if we can pull everything together, we can merge the concerns, we can have some uniform standards that are still regulated at the State level. I do not know of anyplace where anybody is going to get any satisfaction with hundreds of thousands of consumer complaint calls coming into a bureau here in Washington, and those are literally the kinds of numbers that the State insurance departments deal with.

Mr. SHAYS. Could I just follow up a second? It just strikes me, though, that intuitively, costs have to go down to the consumer actually, to the participants, to the insurance industry itself, and obviously to the consumers, if you have a more uniform system. And so I mean, I think you really have to stretch it to make any other assumption. I think choices go up potentially as well if you have more competition, and I think you would encourage more competition.

The other side of it though, it seems to me, is that there is a bit more security on the State level. So it seems to me when I am looking at this, I see a greater opportunity for the consumer with a national system, at least a national option; but on the other side, the potential that if there is a screw-up, if times are bad, you could have—you can have a system that can be more in jeopardy with a national system than if you have the potentially regional State systems, that you will have some good ones and some bad ones, but there will be more protection. That is kind of how I am viewing it as I listen to this hearing.

Chairman BAKER. Thank you, Mr. Shays.

Mr. Bentsen.

Mr. BENTSEN. Thank you, Mr. Chairman.

Representative Young, you talked about your experiences with your bank in having a national bank charter. I have to say when Congress was trying to pass financial modernization over the 20 years that it worked on it, and when we spent—Mr. Baker and I and others spent the last 8 years working on it—it was not the Texas banking commissioner who was up here—who is a friend of mine—that was up here arguing that national banks ought to have some abilities to sell insurance because it was closely related to banking under the Bank Holding Company Act, it was the Comptroller of the Currency. Now I realize he was the bane of existence for a lot of people in the insurance industry.

But there is something to be said for a single-headed dog versus a 55-headed dog who is doing your bidding for you. And that is one thing I worry about this industry; because again, even in the P&C market, and Ms. Spragens makes a very good point when she testified that there are geographical differences. But it is for the most part—I mean we are not a 50-State segmented market. And Ms. Harter raises the issue about agents who are now multi-State agents, and most businesses now I think, a lot of the growing businesses are multi-State businesses, and we have had to grapple with

ERISA at our end in how we deal with that in the health insurance field. So I mean, that is what you are fighting against.

Ms. Harter, in your testimony, if I read this correctly, the PIA board of directors three times has adopted sort of a statement of principles for reform; and in that, you talk about creating a collaborative shared resources uniform effective system. I think that is all well and good. But I am skeptical that 50 States, 50 State legislatures, can adopt a uniform system that preempts each other's State where you may need to have that at some point in time. Federal preemption, of course, can be very unpopular, and other times the industry really wants it badly.

So those are the issues that I think Congress has to address. I appreciate the fact that, well, we do not want another bureaucracy, we do not want another one we have to go through. But last week I was in a meeting with somebody from a national financial services firm which is not one of the big Wall Street firms, it was not a huge conglomerate, but this firm's brokers were a lot like your members; they are NASD, NYSE, they are registered insurance brokers in their State, they are a conglomeration of small businesses; and yet somebody in the home office has to sign all of the documents for all 50 States or wherever they are operating in—I assume it is all 50 States—so it is a convoluted system.

I think those are the issues that we are trying to deal with or the Congress is trying to deal with as we continue to see financial modernization occur, with or without our acquiescence.

So I think it is going to become—the pressure is going to become increasingly greater for some sort of dual system. As Mr. Phillipus said, in reading his testimony, the bigger clients—and it is probably moving downstream—that the bigger clients, for risk purposes, are going to set up these captive companies, because they are becoming multi-State and it is going to be a lot easier.

So I would encourage you—I do not really have a question—I would just encourage you to take a very hard look at how we might be able to come up with a dual system. The States are still going to play a very important role, because the States control the solvency. I do not think anyone is talking about setting up an insurance fund for the insurance industry at the Federal level. I am not sure we want to bite that piece off. But it is a two-way street, because as Mr. Kanjorski said, you know, talked about the terrorism issue that I had raised, the industry has come to us for disaster insurance, flood insurance—which is an important issue in my area of the country, is the federally insured program. So we have to figure out some sort of two-way street, how we are going to work with this market as it evolves.

Chairman BAKER. Thank you, Mr. Bentsen. I just want to make one additional comment.

It is clear that there are areas of agreement where current bodies of rules and regulations are inappropriate; they do not enable the consumer to have any particular right that is of value, they inhibit the free flow of product, they stifle the pricing of product, they inhibit the appropriate conduct of business by the agents themselves. So we can identify those problems.

As opposed to the establishment of a national bureau of insurance with a big office down on K Street somewhere, it seems to me this problem can be divided. On the one hand, commonsense regulatory structure that is national in nature. If we were to take the NAIC approach and make the Illinois model the national model, for example, we are talking about how we get there: Does the Federal end do it or does the NAIC with the State legislature adopt a system, State by State? No big difference. The end of the process would be similar.

On the other side of the coin, however, we do need State advocacy with regard to consumer protections and that the Attorney General and the appropriate insurance regulator would still maintain their right to act and to determine solvency requirements. So that without the necessity of creating a Federal bureaucracy, you could establish national rules by which market practice could be reformed, while reserving to the States the right to defend consumers and to preserve financial protections for the taxpayers.

Somebody tell me why that does not make sense.

Mr. HARTER. It makes all the sense in the world to me. I think it is exactly what we are asking to be done.

Chairman BAKER. Mr. Phillipus?

Mr. PHILLIPUS. I agree. That is the type of—I think we are approaching it from a slightly different approach, but we are not suggesting the creation of a new bureaucracy. We are suggesting we just need a little bit of innovation and we are open to how we get there, but we think the end result is where we need to be and we can make concessions along the way.

Chairman BAKER. This is only 2, 3 hours into the first hearing. We have a long road to travel. But I keep hearing the same things over and over. We are all really saying we see the problem, we disagree on how we are going to fix it, but at the end of the day, we are all going to look pretty much the same. The only question is whether we have a building with a Federal name on it or whether we have just simply national standards of conduct that are applicable in all States.

Representative Young, can you respond?

Mr. YOUNG. I would hope the coalition of NAIC, NCOIL, NCSL, could pull this off without there being a need for a Federal building, quite frankly.

Chairman BAKER. Had they acted in the last 8 or 10 years, I would be just happy as a clam. But I think the problem is that we have been discussing these issues at the national level for quite some time: NARAB, although with some degree of success, is not where we had hoped; and that reciprocity does not look like uniformity; and that at some juncture we could all agree as reasonable people that if it is not done by a date certain, the Congress will act. Maybe that is the message that needs to be related more directly that would encourage constructive dialogue so that the inappropriate Federal intervention would not occur.

Mr. Shays or Mr. Bentsen, any further comments?

Mr. BENTSEN. If the chairman will just yield, I think you are on target, because if you will recall when we did the Gramm-Leach-Bliley bill, the final compromise that was worked out and took forever to get done set these standards that had to be met, and there is still disagreement over whether it is a clear entry into the marketplace, and so the chairman is right. I mean, it may not be—we may be talking about something that is more of a hybrid; we may be talking about something that is more of a federally established SRO-type structure or something that creates this uniformity. Because I think one can make the argument that we have been waiting on the States for a long time to come up with this uniformity in the market. And this has happened in Congress, it happens all the time, the market moves far past us and we are playing catch-up, and I think you all are in that position right now.

Chairman BAKER. As a fairly conservative free market Republican, it is very hard for me to say let us create a new Federal regulator. But something has to be done with the current system, and I would hope that in the time remaining with the record being open, you would respond with your thoughts on the specifics of how such an approach might be constructively considered.

Chairman BAKER. If there are no further comments, our meeting stands adjourned. Thank you.

[Whereupon, at 4:20 p.m., the subcommittee was adjourned.]

INSURANCE REGULATION AND COMPETITION FOR THE 21ST CENTURY

Tuesday, June 11, 2002

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE
AND GOVERNMENT SPONSORED ENTERPRISES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to call, at 2 p.m., in Room 2128, Rayburn House Office Building, Hon. Richard H. Baker [chairman of the subcommittee] presiding.

Present: Representatives Baker, Ney, Bachus, Royce, Oxley, Weldon, Hart, Rogers, Tiberi, Kanjorski, Bentsen, Moore, Maloney of Connecticut, and Lucas of Kentucky.

Chairman BAKER. I would like to call this hearing of the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises regarding insurance regulation and competition for the 21st century to order. Today's hearing is a continuation of the committee's review of current regulatory structure of the insurance marketing and practices with an eye toward determining the advisability of what needed reforms may be considered by the Congress. In the course of these hearings we will hear from a number of participants from various market perspectives, each of whom has recommendations to make to the committee for consideration and subsequent action.

It would be my hope that in today's continuation I am looking forward to the testimony of those who have agreed to appear before the committee, and advise you that the Members will be in and out as the day proceeds, but in order not to delay anyone, we are going to try to be as much on time as possible. Five minutes after is pretty much on time for the congressional committee. So I welcome you and will do so more formally at the appropriate time.

Chairman BAKER. Chairman Oxley, did you have an opening statement for the record today?

Mr. OXLEY. I do, Mr. Chairman, and thank you.

Today insurance represents one of the critical foundations for our Nation's infrastructure. In fact, insurance now represents about 6-1/2 percent of consumer household spending, exceeding entertainment, clothing and health care. Insurance has become an integral part of consumers' lives, and without it, few people would be able to own homes, drive cars, obtain medical care or provide retirement security for their families.

And yet our American insurance market place is entering into a time of crisis. States collect enormous revenues from insurers, spending only a fraction on insurance regulation and on consumer protection. Some States fix prices below the levels necessary to attract adequate capital even where extensive competition does or could exist. And each State imposes its own regulatory regime for formal approval, creating long delays for consumers and making it impossible for insurers to provide products uniformly nationwide. Consumers ultimately bear the cost of this reduced competition and innovation.

The current patchwork system of insurance regulation also has far-reaching international consequences. The financial services marketplace is rapidly becoming more global, with our trade negotiators prying open foreign markets to American products. We could not be strong overseas if we are not strong at home. And we could not argue that foreign markets need to be more open and transparent when our domestic market is still Byzantine and impenetrable.

To remain competitive we need to speak with one voice from our country to harmonize international regulations and ensure adequate consumer protections and solvency oversight. Consumers cannot be adequately protected if insurers are subjected to conflicting requirements at the international, Federal and State levels.

It is my primary hope that our State legislators and insurance commissioners can enact meaningful reform. The States have had some success, significant progress in agent licensing reform, solvency oversight and accreditation. I would note, however, that this success is far from complete and has only occurred in the face of congressional legislative pressure, pressure that will continue to grow if the pace of reform does not improve.

Numerous groups have now come forward to our committee desperate for reform. In fact, some people have tried to take advantage of this by jumping the gun and coming forward with proposals before the committee has had a chance to fully review the great number of issues that Congress needs to analyze in considering any proposals. But we cannot and will not risk such an important foundation of America's infrastructure without understanding all of the risks involved and developing a public record with all industry and consumer groups participating, and that is why, Mr. Chairman, I congratulate what we are doing in this series of hearings. We are just beginning to search out a consensus on what reforms might be achievable. Our goal is an industry that is competitive and profitable and brings consumers the efficiency and effectiveness they deserve.

I appreciate our witnesses coming today to help us grapple with these very difficult issues and look forward to their testimony. I would like to offer a special welcome to Joe Gasper, at present the chief operations officer of Nationwide, a great company that just happens to be based in my home State of Ohio.

With that, Mr. Chairman, I yield back.

[The prepared statement of Hon. Michael G. Oxley can be found on page 136 in the appendix.]

Chairman BAKER. Thank you, Mr. Chairman.

Chairman BAKER. Mr. Moore has indicated he has no opening statement.

Mr. Kanjorski, do you care to make a statement at this time?

Mr. KANJORSKI. I will submit something for the record.

The CHAIRMAN. For the record, thank you, Mr. Kanjorski.

[The prepared statement of Hon. Paul E. Kanjorski can be found on page 229 in the appendix.]

Chairman BAKER. Mr. Rogers, did you have an opening statement? Did you care to make an opening statement, sir?

Mr. ROGERS. Yes, Mr. Chairman, if I may. Thank you, Mr. Chairman.

Just briefly, and I want to first thank the first panel. I do want to talk to an individual who is joining us on the second panel, and I appreciate all of you being here to speak on the dynamic that is happening in the insurance industry right before our eyes and the furious and sometimes adversarial regulation conditions in which you operate in State after State across this country. You are the industry that people love to hate, but it is absolutely crucial that we make sure that you can survive with the free market bent, so you can provide efficiency to those consumers. I am glad you are here today to help us weed through a very difficult circumstance and so we can understand the impact of tort law and sometimes the changing market conditions as we continue to provide insurance services.

I just wanted to take a moment, Mr. Chairman, and welcome Bob Restrepo from Allmerica, and I want to compliment him. Their parent company bought kind of a small insurance company in my hometown called Citizens Insurance. That was the place when I was growing up where people wanted to go to work. They were great corporate citizens. They were involved in every activity in our community. They employed and provided great conditions and a great product, an insurance product. When citizens was purchased, we heard all the rumors that certainly sent a shock wave through a small town in mid-Michigan that they were going to up and leave and be torn apart and sold off and moved in several different directions.

And I want to compliment Bob for taking over and not only continuing that tradition of being a great corporate citizen for our community, but growing and expanding on it, investing in it, moving some operations there, rewarding the very talented people who are there, and making good things happen in our small town.

So for all the bad things you hear about corporate America and mergers, this was a great success story for us and really, I think, for the consumers who are continuing to buy that product. So I wanted to welcome Bob here today. And from Howell, Michigan, a small town in the Midwest, we thank you for what you have done and what you are continuing to do, and the great things you are doing with Allmerica. You are making great changes there for all the right reasons, and we appreciate it. And welcome.

Thank you, Mr. Chairman. I yield back the remainder of my time.

Chairman BAKER. Thank you, Mr. Rogers.

Chairman BAKER. There being no further Members to issue an opening statement, all Members' statements will be made part of the record, and the record will remain open for an additional 30 days for any statements any Member chooses to submit for the record.

Chairman BAKER. At this time, Mr. Tiberi, we would be moving to our panel of witnesses. I understand you may have some interest in making a remark at this time.

Mr. TIBERI. Yes. Thank you, Mr. Chairman.

It is with great pleasure that I recognize one of my constituents actually who is on the panel, the first panel, Joe Gasper, who is the COO, as Mr. Oxley mentioned, of Nationwide Financial, and also a board member of Nationwide Financial, and also president of Nationwide Financial and Nationwide Life Insurance Company; a native of Steubenville, Ohio, and now a resident of Dublin, Ohio, which is the district that I represent.

And Nationwide actually is headquartered in the district that I represent in downtown Columbus. In fact, Nationwide is now developing an area called the Arena District. For any hockey fans in the audience, the Columbus Blue Jackets are Columbus's newest major league team, and thanks to Nationwide in a small part, a wonderful corporate citizen who I have had the opportunity to work with, watched Nationwide grow up, being a Columbus native over the last 30 years, and had an opportunity as a legislator to work with not only the financial company, but also the other companies that Nationwide is involved in.

As the panelists know, Mr. Gasper is chairman of the board of the American Council of Life Insurance, president of the Association of Life Insurance Companies, and a member of the board of the Insurance Marketplace Standards Association. In his spare time in Columbus, he is on the board of Columbus Children's Hospital, and BalletMet, and the OSU Foundation board. He is a graduate of the Ohio State University, where our President is going to be speaking on Friday. It is great to have him here today.

Great to see you, Joe.

Chairman BAKER. Thank you, Mr. Tiberi.

Chairman BAKER. And we would now proceed with our panel of witnesses. For operating procedures we generally try to keep remarks to 5 minutes. Your full testimony will be made part of the official record to enable Members to have as much time for questions after your remarks.

Welcome, Mr. Gasper. It certainly is a privilege to have you here today, and we look forward to your remarks.

STATEMENT OF JOSEPH J. GASPER, PRESIDENT AND CHIEF OPERATING OFFICER, NATIONWIDE FINANCIAL SERVICES, CHAIRMAN, AMERICAN COUNCIL OF LIFE INSURERS

Mr. GASPER. Thank you, Mr. Chairman and members of the subcommittee. Mr. Chairman, there is one thing that just about all the witnesses here in these hearings can agree on, and that is the current state of the insurance regulatory system is lacking in uniformity and efficiency, and these lapses diminish the ability of the insurers to compete effectively in a changed financial services marketplace or to serve our customers' needs in the most productive and efficient manner.

Where we disagree is on the remedy. Life insurers believe that an optional Federal charter, with emphasis on the word "optional," is by far the most effective way to bring the regulation of insurers in line with the needs of consumers and the reality of the financial services marketplace. Today many insurers do business not just across one or two State borders, but nationwide and around the world. Our competition is no longer just other insurers, but foreign and domestic banks, mutual funds, multinational financial conglomerates. The current system requiring virtually every facet of our business activities to be approved in 51 jurisdictions has become an overbearing administrative burden and a competitive albatross. The subject of this hearing, product regulation, is a prime example of that problem.

Banks, among our chief competitors in the financial services market, can roll out an innovative new credit instrument countrywide within 30 days. A similar product developed by a securities firm might take it a bit longer, perhaps 60 days, to meet SEC requirements. For a life insurer the process of getting each states approval can require as long as 2 years. And ultimately, because each State requires something a little different, the insurer winds up with 35 to 40 different products, not just one. The competitive implications of this disparity in regulatory efficiency are enormous and are the major reasons for our pursuit of an optional Federal charter.

But while speed to market is an important reason, it is by no means the only one. Many activities that are routine for other types of businesses are an ordeal for the insurance industry; advertising, mergers and acquisitions, market conduct, company and agent licensing and more. There is a long list of problem areas.

The fact is that the current State-based system of insurance regulation was not designed to accommodate national companies, and it doesn't. That is not to say that it should be eliminated and replaced by Federal regulation. Far from it. Many of the ACLI member companies plan to remain State-regulated. A Federal charter should be an option for those businesses, organizations, products, markets, and strategic plans that would be well served by a less burdensome and expensive alternative.

I would like to close by focusing on two points. The first is that life insurers along with the banking and securities industry now form a triumvirate of essential financial service providers with striking similarities between the three in terms of their mission, their products and their importance to the financial health of the Nation. And yet, unlike banking and securities, there is no Federal insurance mechanism to address insurance issues on a broad scale, no Federal repository of insurance expertise, no agency at the Federal level to address critical issues affecting this multitrillion-dollar industry and its hundreds of millions of customers. The recent debate over terrorism insurance coverage serves only to underscore the existence of this void in Federal insurance knowledge and authority.

To look at it another way, consider what would happen if there was a crisis in the stock market, but no SEC for Congress to turn to for guidance, no Federal securities agency to initiate broad corrective actions to reassure investors in foreign markets. Congress would be forced to query a succession of State securities regulators to try to piece together information on what went wrong and then to come up with its own plans to address the problems, all within a very short time frame and under intense pressure. Can we afford any longer to leave the insurance industry and its customers in a similar position?

The second point is that while we recognize a change of this magnitude will take time, we do not believe that we have the luxury of waiting through two or three Congresses producing Federal legislation aimed only at arm-twisting the States to become more uniform. The States with our full support are already trying to use an incremental approach to regulatory reform. However, incremental changes, while helpful, cannot address in comprehensive fashion the full range of regulatory problems facing our industry.

What we strongly urge this committee to do is to keep focusing on one remedy that can eliminate overnight all the uniformity and efficiency problems that we have, the optional Federal charter.

Thank you, Mr. Chairman.

Chairman BAKER. Thank you very much, Mr. Gasper.

[The prepared statement of Joseph J. Gasper can be found on page 231 in the appendix.]

Chairman BAKER. Our next witness is Mr. Tony Nicely, Chairman, President and CEO of GEICO Insurance, and Chairman of the National Association of Independent Insurers.

Welcome, Mr. Nicely.

STATEMENT OF TONY NICELY, CHAIRMAN, PRESIDENT AND CEO, GEICO INSURANCE COMPANIES, CHAIRMAN, NATIONAL ASSOCIATION OF INDEPENDENT INSURERS

Mr. NICELY. Thank you, Mr. Chairman. Good afternoon, Mr. Chairman and members of the subcommittee. My name is Tony Nicely. I am Chairman and CEO of GEICO. GEICO is the fifth larger private passenger insurer in the United States, employing 18,000 associates. I also serve as chairman of the National Association of Independent Insurers, and it is in that capacity that I am honored to testify before you today. NAII's 700-plus membership comprises all types of insurance companies, writing approximately $98 billion in annual premiums. NAII's diverse mix of insurers provide us a broad perspective from which to comment on the conditions of insurance regulation.

NAII supports State regulation of insurance and opposes Federal involvement in the regulation of the insurance industry. We believe that geographic and State conditions are such that consumers' needs differ from State to State. The goal of regulators should be to balance insurer solvency with an open and competitive marketplace.

Today I would like to highlight two issues, financial regulation and data reporting. A more detailed discussion of these topics is included in my written statement. Solvency regulation is the single most important role that States play in the regulatory arenas. The improvements made to the States' solvency regulatory system over the past 10 years have reduced the number of insurer insolvencies.

Almost all States have adopted the financial requirements of the NAIC Financial Accreditation Standards program. The system is based on strict financial reporting requirements and regular financial examinations. All insurers must comply with financial regulatory standards, including uniform laws prescribing capital and surplus requirements as well as types of investments insurers may hold. All but the very smallest insurers are required to certify and file audited financial statements on an annual basis. The annual statement reporting requirements are far more comprehensive than normal GAAP reporting standards.

It should be noted that the tragic events of September 11, which caused the largest insured loss in history, are not expected to cause the insolvency of a single U.S. Insurer. We think that this is testimony to the general success of the State solvency regulatory system.

While financial oversight is the most important role of the State regulators, State guaranty funds are also critical as the safety net in the event of an insurer insolvency. Since their origins in the 1970s, State guaranty funds have paid out over $9 billion in property/casualty claims to make sure that the promises made to insurance buyers are kept.

In general, the State financial regulatory system is working effectively. We believe Federal intervention in this area is ill-advised and unnecessary. We are also skeptical of any plan to overlay Federal standards over the current State-based guaranty fund system.

The issue of data reporting and availability is another critical area that I would like to highlight briefly. Many States and many small and medium-sized insurers rely on supplemental rating information developed by advisory organizations such as the Insurance Services Offices in order to administer their rating programs. Under current optional Federal charter proposals, insurers would not be required to report data and could be constrained from reporting data because of Federal antitrust exposure. Without the availability of aggregate loss cost data, these smaller and midsized insurance companies would not have credible data and would be unable to compete with larger companies that can rely solely on their own data.

NAII believes that State regulation is the most effective way to achieve a competitive insurance market and to target products to meet local needs. However, we agree that the insurance regulatory system must improve. Progress has been made in the areas of rate and form filing, agent licensing, company licensing and market conduct examinations. State legislators and regulators have particularly—have been particularly receptive to competitive-based reform measures for commercial lines consumers. The NAII believes that such reforms would also benefit automobile and homeowners insurance buyers.

We are confident that the States can and will continue to improve the regulatory system. We will continue to evaluate Federal proposals with an open mind, but believe it is premature for Congress to expand the Federal regulatory role. NAII has completed an extensive analysis of the two optional Federal charter proposals. These two proposals, frankly, generate more questions than answers. They provide such broad regulatory authority to the Federal insurance regulator that it is difficult to assess the ultimate impact on consumers or the industry. All stakeholders must become fully aware of what Federal regulation of insurance would mean to insurance buyers.

Competition and product choices serve the consumer best. Many States are moving toward modernization, but some still need to be prodded. Ongoing oversight by this committee can help impress upon those States the urgency of acting now. We believe modernization at the State level is an achievable goal.

And in closing, the NAII believes that a flexible, innovative and competitive State regulatory system is the most efficient and cost-effective way to deliver protection to the insurance buyers. Thank you.

Chairman BAKER. Thank you very much, Mr. Nicely. We appreciate your testimony.

[The prepared statement of Tony Nicely can be found on page 258 in the appendix.]

Chairman BAKER. Our next witness is Mr. Donald Young, who is President of the Health Insurance Association of America. Welcome, Dr. Young.

STATEMENT OF DONALD A. YOUNG, M.D., PRESIDENT, HEALTH INSURANCE ASSOCIATION OF AMERICA

Dr. YOUNG. Yes. Thank you, Mr. Chairman, distinguished members of the subcommittee.

The members of the Health Insurance Association of America provide a wide range of health insurance products, including medical, dental, supplemental, long-term care insurance and disability insurance. I am delighted to have this opportunity to provide our views about the general issue of insurance regulation.

Health insurance is primarily regulated by the States. However, health insurers are also increasingly subject to Federal laws. Proposals before the Congress such as the Patients' Bill of Rights would dramatically expand this Federal role. The regulation of health insurance is complex. Many everyday health insurance functions simply have no other counterparts in other types of insurance.

While HIAA has long supported the State regulation of insurance, we also recognize that there are issues that need to be addressed, such as speed to market, and inconsistencies between Federal and State rules. Privacy provides a useful example of the interaction between Federal and State laws and difficulties that can arise for insurers. Congress addressed privacy in HIPAA, but HIPAA does not preempt all State privacy laws. Instead State laws more restrictive than Federal requirements continue to apply. As a result, insurers must determine for every State in which they do business whether State law is more or less stringent than the Federal requirements. And some States continue to adopt new privacy laws. Therefore, the comparison cannot be a one-time endeavor. The bottom line is that current law forces an insurer operating in multiple States to implement multiple privacy plans incurring greater expenses than would have been the case if a single uniform privacy law applied. This could be said for other issues regulated by both Federal and State laws.

One suggested solution for the regulatory problems is the optional Federal charter. Under this concept, federally charted insurers would primarily be regulated at the Federal level. HIAA has not taken a position on any of the pending optional Federal charter proposals. However, establishing an optional Federal charter appears to require several steps. First policymakers need to carefully review existing State regulatory and other oversight roles. Next they must decide which of these should be replicated in a Federal regulatory structure. Finally, for each issue, and there are many, they need to identify the specific regulatory policy that will apply to federally regulated insurers.

All of this is a significant challenge. As currently drafted, optional Federal charter proposals provide very little in the way of the statutory framework for regulating health insurance products at the Federal level. Rather, they defer most decisions to Federal regulators.

I would like to end by acknowledging that the States, through the NAIC, the National Association of Insurance Commissioners, are making serious efforts to streamline the regulation of insurance. The NAIC is also now exploring the use of interstate compacts as a way to improve consistency and reduce the regulatory burden. Such compacts raise a host of structural process and policy issues. We are working very closely with State insurance regulators to help assess these matters.

HIAA would welcome the opportunity to work with members of this committee as you continue to examine the important issue of the regulation of insurance. Thank you.

Chairman BAKER. I thank you, Doctor. We appreciate your testimony today.

[The prepared statement of Donald A. Young can be found on page 309 in the appendix.]

Chairman BAKER. Mr. Nicely, last year in a hearing which we conducted on speed to market issues, you participated and in the course of that hearing indicated that the competitive rating system that Illinois has adopted was a favorably viewed methodology. Do you still view the Illinois model as one which is—offers advantages?

Mr. NICELY. Yes, Mr. Chairman, we do. It is not the only model, but it is certainly a model that we favor. Frankly, we have not found, and I personally have not found, anything in a nonmonopolistic society that serves the consumer better than the free market system that we have in this great country, and Illinois has that system. Certainly other States have similar systems that would be file-and-use systems. And two States that had very onerous regulation of rates, South Carolina and—actually a jurisdiction, meaning the District of Columbia, and a few years back moved to an open rating system, and they have found many new players and rates stabilized.

So, as I spoke to the National Association of Insurance Commissioners earlier this year, I believe that any commissioner who has worked in an open-competition State would say that it has served their citizens well.

Chairman BAKER. Certainly. In order to get to that perspective, a national basis, and being reliant today on the State leadership to achieve that end, what would be your expectation if you had to run a clock on seeing a 50-State uniformity initiated either by the NAIC, State insurance regulator or whatever moving force might be out there to get such a—or how long should the Congress wait before we act? At some point, I think we agree that there is some level of difficulty in the markets today because of inefficient regulation. And one day we are going to have to take action. How long would you suggest the Congress wait?

Mr. NICELY. Let me answer that question this way, Mr. Chairman. I believe that even the toughest States are now beginning to see the light because of a number of reasons, and one of those reasons is that we are having a much better informed consumer today than we have ever had in our history. Let's take one of the toughest States of all, the State of New Jersey. Things have gotten so bad in New Jersey and consumers so riled up by paying the highest automobile insurance rates in the Nation that the Governor has—himself has recently said, I propose modernization and will work to do everything possible to modernize the regulatory system in the State of New Jersey.

It is my belief that other legislators will also begin to feel that way because the consumer, as was said in the opening statements by Chairman Oxley—consumers deserve better than paying higher rates than they should. And I believe that even tough States like New Jersey we will see moving forward. If we see no progress at all, then I would say more is required. But I believe even New Jersey we will see some progress in the very near future.

Chairman BAKER. Well, in the interim would there be—would it be ill-advised to move forward with the proposal that would take the Illinois model and make that a national plan? I mean, is there any downside to that?

Mr. NICELY. In my personal opinion, yes, sir, because as soon as you begin to tell the States that they have to use one form of competition over another, we are likely to get some political backlash.

Chairman BAKER. But if it is optional?

Mr. NICELY. If it is optional, it is still the same way, because I believe that when we get into optional—if we just have optional ratemaking, that is not likely to happen. So when we say optional, we say an optional Federal charter that would get into things like how do you handle residual markets, how do you handle reparations, what law do you use for tort, and many other things.

So I don't think that you could just cut this up into little bitty pieces and say, well, we will just impose open rating on every State. If we could do that, that would be wonderful, but I don't believe that that would be possible.

Chairman BAKER. I thank you.

Mr. Gasper, I know you don't necessarily share that view, but what sense of urgency do you have as to the need for reform? I have, of course, read your statement, but if we knew we could get where we need to be in 2 years, is that too long?

Mr. GASPER. Mr. Chairman, I don't have to live in your reality of politics, but I would suggest to you that we are almost 15 years too late. Keep in mind that I am here as the president of a life insurance company, and I am representing an organization that represents life insurance companies, not property/casualty. I could make the case that the automobile business is a State oriented business, but the life insurance business is a national business. But if you look at this in terms of what happened in the mid-1980s in this country, with high interest rates and then with the equity markets, the whole business has changed. It is no longer a life insurance business. We are a top 10 life insurer in the United States, and we get 40 percent of our premium through payroll deduction. It comes to us every 2 weeks through 401(k) plans or 457 plans for cities, counties and States in the United States. So think about it. Whether or not you think of it as a life insurance company, 40 percent of our business is coming from retirement savings plans.

And so the market has changed dramatically. Life insurance is now a national business. It is really an international business too in some respects. It is not life insurance, it is retirement savings. It is about long-term savings, and what we have is a regulatory system that essentially is regulating it like it was traditional life insurance 40 years ago.

So the idea of waiting 2 years for real reform is not appetizing to me because I think we are essentially behind the times for this particular industry. And I keep emphasizing how we compete against banks and how we compete against security firms. We are not just competing among ourselves. If we were just competing with insurance firms, we would all be disadvantaged equally, but our competition is coming from mutual funds and banks.

Chairman BAKER. Thank you, Mr. Gasper. My time has expired. Mr. Kanjorski.

Mr. KANJORSKI. When you say "this industry," now you are talking about the subset life insurance industry or the insurance industry as a whole?

Mr. GASPER. Well, I am speaking for the subset life insurance industry, which is the life, annuity and long-term savings retirement industry.

Mr. KANJORSKI. So your theory is we could create tiers identifying different aspects of the industry. But I suspect that Nationwide handles other insurance products, doesn't it, besides life insurance?

Mr. GASPER. Nationwide is a large property/casualty insurer, writes a tremendous amount of—.

Mr. KANJORSKI. What does that side of the company—.

Mr. GASPER. Well, I think that Nationwide, Nationwide in total as an enterprise likes the idea of insurers having an option. We are not talking about doing away with State regulation. We are talking about giving individual companies choice—so if Mr. Nicely's company wants State regulation and wants to remain State-regulated, he can. If GEICO decides that it wants to be federally regulated, it can. So all we are asking for is choice.

Mr. KANJORSKI. In all aspects, though. You are not just talking about life insurance.

Mr. GASPER. In all aspects, from my company's point of view. From the industry's point of view, as I sit here today as chairman of the ACLI, I am speaking for the life insurance industry.

Mr. KANJORSKI. All right. Mr. Nicely, your company is nationwide, without the trademark name. You sell life insurance, don't you?

Mr. NICELY. No, sir, we sell in 48 of the 50 States. We do not sell in New Jersey or Massachusetts because of the owners' regulation there.

Mr. KANJORSKI. Okay. Well, and you honestly don't see any damage to having a level playing field nationwide? You are very satisfied with the present State regulation?

Mr. NICELY. Very is an overstatement, sir. We are satisfied. We certainly believe that State regulation must improve. We also believe that it will improve. There has been gradual improvement in all aspects of the regulation and in some States much greater than others.

Mr. KANJORSKI. We seem to be pushing the States to do that, though. I am wondering whether they have—what their own inclinations would be.

Mr. NICELY. Many of the States are doing it on their own. Some are doing it because they are being coerced, and others are just so resilient that they haven't moved yet. But as I said, and in answer to the Chairman's question, I believe even those States are beginning to see the light and will make the changes. The consumer is going to demand it.

Mr. KANJORSKI. What would you think if we looked at an optional charter that was tiered either to specific aspects of the industry or to the size of the companies involved, and giving that sort of an option? Those companies that are—I don't know what the rate is, but equivalency of having 10 billion in assets in banks, whatever that would be comparable to, to give them a high tier and give them an option for a national charter, but the lesser companies to say—.

Mr. NICELY. I certainly wouldn't recommend that. Now, if you want to consider the tier on the basis of carving out certain segments of the industry, such, as Mr. Gasper said, the life insurance industry, that may be possible. We don't write life and wouldn't propose to speak for the life insurers, but I can certainly see the legitimacy of some of the arguments being made by Mr. Gasper. But the property/casualty is such a complex industry that goes to so many of the laws of the various States that carving that out with a national charter is so complex that I believe it will take several years just for all of the players even to understand what is being proposed as you do that.

Mr. KANJORSKI. Don't you see sometime in the future, though, your company expanding to cover all aspects of insurance?

Mr. NICELY. Not necessarily, because we are one of those companies that believe if you can do one thing better than anyone else, it might be more profitable than trying to do a lot of things as well as anyone else. We simply would like to be the best automobile insurer in the Nation.

Mr. KANJORSKI. Don't you think if you get particularly successful, some hawk will be circling and maybe taking—.

Mr. NICELY. Well, of course that is probable, and when we get there, of course we may have a different view on how large we would like to be. But right now we only insure 5 percent of the autos in the Nation, and we would like to insure a larger number.

Mr. KANJORSKI. You raised an interesting question that has disturbed me a little bit, that if we move too precipitously on this question, we invite a hearing 2 years or 5 years from now on the question of adopting tort law standards, because obviously the distinctions in premiums and rates are very closely aligned with the tort law of the particular State involved. Do you see this as a potential problem that we —.

Mr. NICELY. I certainly do, in the highest of magnitude. Of course, in a way this debate goes back 200 years from Adams and Jefferson as to what really is best left to the States, and under the property/casualty industry, the needs in Alaska are very different than Texas, and Texas is very different than Florida and New York, et cetera. And I certainly wouldn't propose that a lot of the things, financial responsibility for instance—in certain high-income States it is the States have judged that they should have a higher level of financial responsibility, and other States it is much smaller. So you really do open the proverbial Pandora's box.

Mr. KANJORSKI. What do you think about the question on tort law? And I might say not only tort law, but contract law, because certainly that is going to bring in all the different inconsistencies in the various States. What—how do you respond to that, Mr. Gasper? What should we do in regard to that?

Mr. GASPER. I think the answer revolves around two different industries. And so as Mr. Nicely has described the property/casualty industry, especially the auto and homeowners end of it, these are very important issues, and I think the States vary widely. When you talked about life insurance, which is essentially a national product, we don't see a lot of difference in terms of the statutory requirements inside a State or even what goes on in terms of the courts within the State that would really matter in terms of life annuity and long-term savings.

Mr. KANJORSKI. But that is part of your company that also is in favor of a national charter that handles the same type of insurance as Mr. Nicely's company. What would they think about the question?

Mr. GASPER. What would Mr. Nicely's company think?

Mr. KANJORSKI. No. How would your side of the company that handles casualty and loss deal with the tort and contract law?

Mr. GASPER. I think that our company would essentially say that Mr. Nicely should have a choice. If he believes State regulations make sense for GEICO, he should be able to stay there. If Nationwide's property and casualty operations thought that it made sense to be a nationally regulated company in order to get to market quicker or lower cost, it should have that choice. All Nationwide is asking for is a choice.

Mr. KANJORSKI. All right. Am I overtime—my time has expired, Mr. Chairman.

Chairman BAKER. Thank you, Mr. Kanjorski.

Mr. Ney.

Mr. NEY. Thank you, Mr. Chairman. I want to welcome all of the panelists today. I think it is very obviously an important subject, and I appreciate the chairman's desire to get this all out on the table.

I would like to start with Mr. Gasper, welcome, being from Ohio, and also treat you pretty nice. I had a leak this morning in my ceiling, and you can guess where I am insured.

Let me just lay something out here that obviously is pretty understandable. Federally-chartered companies will be exempted from State-imposed market conduct rules. We know that. So if a consumer from our State were to go with the federallychartered and, say, you know, with you all, and they would be under a different set of sales rules than a consumer that would go with a State-chartered company, so that consumers would be entitled to different illustrations, lemon laws, et cetera. I mean, I think we all agree that that is the way the system would work.

So it goes to the point—I understand what you are saying about choice, and there is an opt-out provision, but the scenario I described, don't you think it is going to be confusing for the consumer to be able to shop within the States and have to do an awful lot of groundwork?

Mr. GASPER. I think it gets confusing for consumers now. If I buy my life insurance or annuity policy in one State then I move to another State, am I still being regulated by the State that I was in? I think from the standpoint of life insurance, annuities, 401(k)s, I think the consumer's perspective is that they should be able to get the same kind of quality, the same kind of protection, in every state.

So my view would be that if consumers fully understood all the nuances that occur in 51 jurisdictions and the fact that when we get a product approved, many times we have to have 40 different requirements for the same product because there are 40 different applications for the same product because that is how the States operate, I think the consumers would be totally bewildered by that considering what they believe they are buying.

Mr. NEY. Of course, if you move from one State, you still know what the rules were when—you know, when you incurred that policy in the State that you lived in. But I just—and I want to go back to one other thing. Also, Mr. Nicely testified about State regulators, the 1980s, some of the problems. I have got some, you know, information up here, and some of the things from your testimony, it points out that they did a better job when they needed to. I am just wondering what your comment would be, Mr. Nicely, on the fact that, you know, what about if we could get the State regulators to once again, if they want their jurisdiction upheld, to be able to look at ways to streamline some of the problem areas? Do you think they could do that or not?

Mr. NICELY. Of course they could, and I think they can. If you are asking a question does oversight by this committee—is it useful, and may it speed up the process, yes, I think the answer to that is true also.

So I commend the committee for your oversight and hope that you will be one of those interested, very interested parties that helps to keep the pressure on the States to bring about these reforms.

Mr. NEY. This may be an observation. I have dealt for years with the HIAAA, of course with Nationwide and others, and different insurance entities over the years. I chaired insurance and financial institutions in the Ohio Senate when I was there. And, you know, the Bible was McCarran-Ferguson. The Bible was State regulation. That was the first things. Once you got that out of the way, you could have a nice conversation with each other. You know, where did you stand on that issue?

And the only thing—I understand about expediency. I do look at the bottom line end to the consumers and how they are going to be confused or not on choices, because they will be dealing in some cases, even if there is an opt-out, with the Federal Government. I just—it is hard, I think, for a lot of people—maybe not others, but a lot of people over the years have had one mind-set to understand how possibly you can shift jurisdiction, and how many new staff do the regulators have, and do they promulgate rules and regulations that we are so busy we can't even keep up with particular oversight of those, and what happens to the consumer in those cases. And maybe you will be back here in a few years saying, oh, my goodness. Look what is happening to us. So I—you know, there is a lot to be talked about. But I think I just find it hard to understand how that—what caused this whole shift to go towards, you know, the Federal Government is better. We are here from the government and here to help you.

Mr. GASPER. I would not make the case that it is better. I am making the case about a choice, about an option. There are many banks that inside their organization will have a federally chartered bank and a State-chartered bank. I can see big organizations having federally chartered life insurance companies and State-chartered life insurance companies within the same family of companies. So it is not about better or worse. It is about choice. And a little competition could occur between the regulatory bodies in terms of who is the most efficient. Who is the one that basically is doing the best job for the consumers. So it is not about better or worse. It is about choice.

Mr. NEY. Thank you.

Chairman BAKER. Thank you, Mr. Ney.

By time of arrival, Mr. Moore, you'd be next if you have questions.

Mr. MOORE. Mr. Gasper, every State already has in place safeguards to protect insurance consumers, and these protections would vary State by State. And I guess my question to you is what consumer protections would be necessary if we created this optional Federal charter that you are proposing here?

Mr. GASPER. I believe that in our proposal essentially we are not trying to eliminate anything in terms of consumer protection. As a matter of fact, I think we are trying to strengthen it by streamlining it so that it makes sense on a national basis.

Our view would be that the State regulator would promulgate rules for state chartered companies. The Federal system would build on that, but would be uniform across the country. And there would be little distinction between State and Federal regulation when it comes to protecting consumers.

Mr. MOORE. Do you believe the proposal that you have right now, the draft proposal that you have now, speaks to that adequately?

Mr. GASPER. I think in concept, it does. I think the devil is always in the details, and I think we have to flesh it out, but I think the makings are there to essentially bring all of the protections that consumers have today into the Federal system, and then the plus could be streamlining those so that they are better understood by the companies and the consumers and less costly to administer.

Mr. MOORE. You have talked, Mr. Gasper, about a proposal I think is modeled similarly to the dual banking system that regulates commercial banks, thrifts and credit unions and is optional.

Does yours apply though your proposal only to life insurance lines or other lines in the insurance industry?

Mr. GASPER. As I mentioned, I am here representing the life insurance industry as chairman of the ACLI. My own company as a major property/casualty company does support the concept of choice.

Mr. MOORE. You say does?

Mr. GASPER. Does support the concept of choice. But as I think about the issue of life insurance, I am absolutely convinced that it is a national business, it is not a State business, and that Federal regulation would make more sense in terms of efficiency.

Mr. MOORE. To the other two panelists, Mr. Nicely and Dr. Young, I guess my question would be if you would support or not oppose a limited charter for regulation of only life products, and why or why not? How do you see this?

Mr. NICELY. The NAII has not taken a position on the life side. Personally I would not oppose it. I mean, I can certainly see some of the arguments that the life insurers are making, but it is a very different ballgame when it comes to the property/casualty side, Mr. Moore and Dr. Young.

Dr. YOUNG. We also do not have a position. An important question would be, though, the nature and scope of the charter and how it would work. Would the charter be given to a company—if the company is in life and long-term care and medical and a variety of businesses, would that charter apply, in which case health would be drawn in, or long-term care would be drawn in? So an important question is how the charter would work, or, conversely, would the charter work by line of business or by specific product? All those kinds of issues would have to be hammered out before we could really look at that effectively.

Mr. MOORE. Thank you.

Mr. Gasper, does a vote in favor of pursuing an optional Federal charter bill in Congress suggest that most of the members of your association would choose Federal regulation over State regulation?

Mr. GASPER. I am not in the position to say that. I know there is a large, very large mutual insurance company inside the association that has indicated that it would stay State-regulated, but we have not had any poll. If I were to guess, I would think there would be a lot of companies that would stay State-regulated. These would be regional companies.

Many of our member companies only do business in a handful of States, and the markets they serve are more traditional in terms of life insurance. I would think that the large national companies that are more in the retirement savings business, the long-term savings business, would look with a strong eye towards a national charter.

Mr. MOORE. Thank you, Mr. Chairman.

Chairman BAKER. Thank you, Mr. Moore.

Mr. Royce, you would be next.

Mr. ROYCE. Thank you, Mr. Chairman.

Mr. Gasper, a prominant insurer in my part of the country has described to me a case where one State's onerous product approval process prevented the insurer from offering a life insurance product which had a lower cost and lower insurance rates, due to the bureaucratic costs involved in that State's justification process. Now, from my standpoint, it makes sense if you have got a scenario where regulators would require justification for an increase in rates, but it is a little difficult to see why the administrative process should be prohibitively burdensome for insurers seeking to bring lower-priced insurance products to the consumers in that State. And I believe it is part of an unintended consequence of different States' regulatory processes that allows consumers in one State to benefit from lower rates while the consumers from another State are barred from enjoying those lower rates, when the only justification that I can see for this price differential is the bureaucratic process, not specific underwriting facts. And I wondered if this is the kind of example that your own company has run into, or perhaps you are cognizant of this situation where others in the industry have run into this type of situation? Mr. Gasper, could you respond on that?

Mr. GASPER. Yes. I could give you many cases for my own company. And when I asked the ACLI member companies, I was literally inundated with cases. The one I remember in addressing the NAIC was we came up with a product which was a combination annuity/long-term care product that we thought was very attractive to help people start to save for long-term care in an annuity format. We had some very large States approve it, and we had some very large States not approve it. And, you know, we were taken aback by it. I mean, it is the same policy.

So, yes, there are many, many instances where we essentially will take a product, file it in a majority of States, and have at least four or five big States with large populations not approve the product or take 2 years to approve the product.

Mr. GASPER. And then when the product is finally approved, you know, something else has become more popular. So it is a problem.

Mr. ROYCE. Well, I thank you, Mr. Chairman. I thank you for calling this hearing, and we will look forward to hearing from the second panel.

Chairman BAKER. Thank you, Mr. Royce.

Mr. Bentsen?

Mr. BENTSEN. Thank you, Mr. Chairman.

Mr. Nicely, you mentioned that in the property and casualty business, it is obviously different in Alaska than it is Texas and New York, et cetera. I guess the problem is, I think everybody has agreed, that in the life insurance market, that there aren't 50 different markets, there is one national market; and—but in the property and casualty market, you are arguing there are still 50 or 51 different markets. But do you all allocate your capital? You are operating in 48 of those 51 markets. Are you allocating your capital to the number of policies that you write based upon the capital that you raise from each of those markets, or do you raise your capital in a national market and then allocate differently?

I mean, I guess the point is aren't you subsidizing in some cases one State's operations against another State's operations?

Mr. NICELY. No, sir, we don't. That is one of the reasons why we do not operate in New Jersey and Massachusetts, because at one time we were licensed to write in both of those States, and we chose not to allow customers from other States to subsidize those two States. So while our capital is not allocated to the various States, it is certainly sufficient to protect the consumers in all of those States. And of those 48 States and the District of Columbia that we do business in, we want to grow our business in all of those States.

Mr. BENTSEN. Mr. Gasper, in your testimony, you talk broadly about what a Federal charter would look like, and that it would take over the regulatory apparatus of the States, an optional Federal charter. Mr. Nicely in his testimony talks in great length about State guaranty funds and the necessity of them. Is the intention of a Federal charter, for those companies which opted into a Federal charter, that there would be a new guaranty fund that they would also opt into, or would you maintain the State guaranty fund?

Mr. GASPER. Initially the best way to think of all this is you take what you have and you let federally chartered insurers participate in it, and then you give the regulatory authority the opportunity to improve it as things change.

Mr. BENTSEN. So you would have a Federal guaranty fund or not?

Mr. GASPER. I just got a note here; someone is going to help me get a little more specific.

Essentially, we would preserve the State guaranty funds and have federal insurers become part of the State guaranty system.

Mr. BENTSEN. So, Mr. Nicely—or let me ask the entire panel this. Then you really would have a form of dual regulation in the banking system. For instance, you know, if you are a State bank, you are regulated by the Fed, and you are also regulated by the F D I C, and both those entities have regulatory powers theoretically for the benefit of consumers, for the benefit of safety and soundness. Under your proposal for a Federal charter, if an entity opted to take the Federal charter, they still would be under some State regulation for purposes of their membership in the State guaranty fund?

Mr. GASPER. Essentially the way to think about it is that the insurer is protected by this in the State in which its policyholders live. The national charter system would essentially suggest that national insurers would get the benefit of the existing guaranty system. That is how we would see it playing out.

Mr. BENTSEN. But they would stay within the State, whichever State guaranty fund. If they are in the New Jersey or whatever, they would stay within that, and the New Jersey regulator would oversee their capital adequacy?

Mr. GASPER. Yes. It is about aggregating those funds. But it is essentially, regardless of where you would live, with a federally chartered company you would have the protection, and it would not vary by which State you are in and where you are insured.

Mr. BENTSEN. Thank you.

Thank you, Mr. Chairman.

Chairman BAKER. Thank you, Mr. Bentsen.

Mr. Bachus?

Mr. BACHUS. Thank you, Mr. Baker.

Mr. Gasper—well, I will ask all of the panelists this, anyone that is familiar with this. And what I am talking about is Federal efforts to promote State uniformity in regulations. In Gramm-Leach-Bliley, we adopted the NARAB Licensing Provisions. Has licensing of agents been any easier than, say, it was 3 years ago as a result of those attempts?

Mr. GASPER. I would say that there have been improvements. Have we gotten to what we would think should be sort of the national way of doing it? The answer is no. I think there are still 30 percent of the producers or agents who sell insurance that are not under the system today.

Mr. BACHUS. I think we didn't really go as far as some advocated or as we could have gone in NARAB, and I think several States are still holding back. But maybe do you anticipate when those States get on board that we will?

Mr. GASPER. It would be difficult for me to say by State. Again, I am giving the States the credit for the progress. But getting 70 percent is not what I think we need to run the business.

Mr. BACHUS. All right.

Mr. NICELY. I certainly would agree. There has been a large improvement, but it is not perfect yet.

Mr. BACHUS. Sure. Do you think that was maybe because some States have lagged behind, or do you think that is because we didn't go far enough in Gramm-Bliley-Leach, Gramm-Leach-Bliley? Or do you think that that is just not the right solution?

Mr. GASPER. I think it is the nature of the beast if your objective is uniformity and speed. I think it is the nature of having 51 jurisdictions working with different legislatures which makes it a tremendous uphill battle. The wind is clearly in their face for getting to complete uniformity.

We believe the life insurance industry needs to be regulated to compete with the mutual fund industry, to compete with the banks, to compete with the securities firms. I mean, that is the standard that has been set. Our competitors basically have defined the level playing ground that we must get to. And the idea that we might be able to get to 70 percent or 80 percent of that is essentially unacceptable as we try to compete.

Mr. BACHUS. What you are talking about, when you say securities companies or banks, you are talking about their ability to raise capital as opposed to your ability because of the current regulatory structure?

Mr. GASPER. I think that in terms of the education process for this committee, when we say life insurance, I think we initially think about traditional life insurance.

Our industry has evolved and my company is heavily involved in the retirement savings, long-term savings business. So essentially we are competing for 401(k) business. Okay. Nationwide is the third largest administrator of 401(k)s in the United States. Most of our employers have less than 100 employees. We are not issuing life insurance contracts for those employees; it is the 401(k) business. We are competing with Fidelity, with Schwab, with Citibank, with other mutual funds. That is the market we find ourselves in.

So that is the point I was trying to make; that if you go back to 1970, we are all trying to sell traditional life insurance. Today the vast majority of the companies are trying to compete in the long-term savings retirement business.

Mr. BACHUS. Do you have a disadvantage over banks and securities companies in raising capital because of the current regulatory structure in insurance?

Mr. GASPER. As a public company I don't think we have any more limitation in terms of raising capital. I don't see it as an issue.

Mr. BACHUS. Do you have limitations?

Mr. GASPER. The only thing inefficiant regulation would bring into it is that it does put our industry at a disadvantage as we try to compete for the retirement savings; and, to the extent that we get a smaller share, we are going to get smaller earnings increases. And that certainly relates to our ability to raise capital.

Mr. BACHUS. Okay. No more questions.

Chairman BAKER. I will just take the balance of that gentleman's time then.

I would also make the point that a bank selling an annuity doesn't have to go through the 50-State approval process that a life insurance company selling a similar product called life insurance has to go through.

Mr. GASPER. Well, that became interesting as the banking industry sort of was manufacturing annuities and not having to go through the State regulatory system. Today they do. In essence, they would have to. We sell a lot of annuities through banks as such.

Chairman BAKER. Thank you, sir.

Mr. Lucas?

Mr. LUCAS OF KENTUCKY. Thank you, Mr. Baker.

Mr. Gasper, I am wondering, having been in the life insurance business for 30-some years and seeing the companies go through the trials and tribulations of trying to get product approval, I can't think of a reason why we shouldn't modernize under one system, because I would think that the consumer would be so much better off and the products would be much more cost-effective. It is kind of like you are competing against the banks and the mutual funds with one hand tied behind your back maybe for a year or 2 years or 3 years, or with both hands tied behind your back in some cases when you can't get the product approved.

I just can't understand why the life insurance business wouldn't—you know, I am not for bigger government, but, you know, one size fits all here, and I just can't see any good reason why we shouldn't do this on a national basis. Is there any? Am I missing something here?

Mr. GASPER. I think you are right on point. I think, when you step back and look at the business, the nature of the business, it is a national business. It is a business, and it has changed dramatically in the last 30 years. Banks are selling insurance, stock brokers sell insurance. It is—traditional insurance agents are selling insurance. So it just screams for the idea that it is a national product, and it screams for an opportunity for companies to be nationally regulated.

Mr. LUCAS OF KENTUCKY. It just seems like to me that this is a lay-up shot and a no-brainer. I don't know why we would get resistance on this.

Mr. GASPER. Well, that is how I would see it, but I am pretty naive when it comes to—.

Mr. LUCAS OF KENTUCKY. So am I.

Mr. GASPER.—when this is all done.

Mr. LUCAS OF KENTUCKY. So am I. Thank you.

Chairman BAKER. Thank you, Mr. Lucas. I am sure somebody will be around to explain it.

Mr. Tiberi? Do you have a question, Mr. Tiberi?

Mr. TIBERI. Yeah, I do. I have a couple questions, Mr. Chairman. Thank you.

Chairman BAKER. Sure.

Mr. TIBERI. To Mr. Gasper first off—and I wish my colleague Bob Ney were here, because he was the chairman of the insurance committee in the Ohio Senate. But I think that just over the last 10 years, the life insurance industry has changed significantly. And the point that I am going to make, and I would like you to comment on it because you have touched on it already a bit, and that is the life insurance industry becoming much more different than my dad's life insurance. The point that I am going to make is as a public employee in the State of Ohio, as a State legislator, and as any public employee through the State of Ohio, through the Ohio deferred compensation system which was started in the early 1990s, you get a sheet of different options as a public employee that you can invest in through deferred compensation; and you have what you would expect to have there, and that is banks as options, securities firms as options, and then you suddenly have Nationwide Insurance Company, which I think of today still as a property and casualty company, but yet Nationwide is a huge player in the State of Ohio in that market competing with banks and insurance companies.

Can you touch upon how many States you, as Nationwide Life, today are in with those types of plan?

Mr. GASPER. We are the largest insurance company involved in section 457, public sector plans. We probably now are involved in at least seven or eight States. We are endorsed by the National Association of Counties; we are endorsed by the United States Conference of Mayors. We probably have over six or seven cities and counties throughout the United States, and those are large counties like Cook County in Chicago, but small counties where there might only be 35 or 40 employees, and in most of those large cities and counties, we are doing exactly what you described: We are having to put our options against bank options, credit union options, mutual fund options, and we compete, and the employee gets all those choices. And it is wonderful for employees to have those choices, but when it takes us an enormous amount of time to get products approved to participate in those plans, we are disadvantaged.

Mr. TIBERI. And so today, Mr. Gasper, you are operating much more like a bank or a securities company as the head of a life company within a larger structure than you are to your sisters within the Nationwide Company that are in the property, casualty, and health business; am I right?

Mr. GASPER. Right. In the past, with traditional life insurance, the main concern was dying too soon. Now, there is still an enormous business there, and Nationwide participates in it. But what

Americans are concerned about is living too long, outliving their income, and that is essentially what we are trying to compete in and the business we are trying to compete in. And it's only the industry essentially today that can guarantee you an income for life. You can give an insurance company X amount of dollars, and they can guarantee you an income for life. So it is not like your father's life insurance company, nor my father's; it is—again, I keep calling it the retirement savings, long-term savings business that we are competing in. And we are competing with other insurance companies, but we are also competing with banks, mutual funds, and securities firms.

Mr. TIBERI. Just to switch directions a little bit, you spend most of your time in Ohio. Ohio, like many other States, has struggled with revenues. One of the criticisms that has come from this proposal is that States like Ohio would lose revenue if they optioned into the Federal system. Could you comment on that?

Mr. GASPER. That is a great question, because the proposal as we outlined it, the premium taxes would stay right inside the State, and we would expect the companies, you know, to pay their fair share of taxes in the States. So the premium tax would stay in the States. And if you look at how States tend to regulate insurance, essentially what they do is charge the companies for the regulation that occurs. And my suspicion is essentially States are losing money regulating insurance companies today. So they would keep the premium tax and get out of a business where essentially they are not making money today.

Mr. TIBERI. Thank you.

And one last question, Mr. Chairman, for Mr. Nicely. From your perspective, as a property and casualty company only, do you have the same competitive issues that banks and securities and health companies do? Or, the issue that somebody touched on earlier, the speed to market issues that life insurance companies have today?

Mr. NICELY. Not really. All insureds are required to go through the same process. So while in some cases it may be onerous and too long, at least there is a level playing field.

Mr. TIBERI. Thank you.

Thank you, Mr. Chairman.

Chairman BAKER. Thank you, Mr. Tiberi.

Gentlemen, we very much appreciate your participation in our hearing today. The record will remain open not only for Members to express further opinions, but for you as well should you have an addendum to your own remarks here today. We certainly appreciate your time and assistance in this difficult matter. Thank you.

Chairman BAKER. And I would ask at this time if our panelists are available for the second panel to come on forward, please.

I would like to welcome each of you to our hearing this afternoon. As you know, we request that your testimony, as best can, be contained to 5 minutes. That would be helpful. And, of course, your entire testimony will be made part of our official record.

With that, I would like to first introduce Mr. Robert Restrepo, Jr., President and CEO of Allmerica Property and Casualty. Welcome, Mr. Restrepo.

STATEMENT OF ROBERT P. RESTREPO, JR., PRESIDENT AND CEO, ALLMERICA PROPERTY & CASUALTY COMPANIES, INC., CHAIRMAN-ELECT, AMERICAN INSURANCE ASSOCIATION

Mr. RESTREPO. Thank you very much, Mr. Chairman. As you mentioned, my name is Robert Restrepo, and I am President and CEO of Allmerica Property and Casualty Companies, located in Worcester, Massachusetts. Our two flagship property/casualty insurance companies are Hanover Insurance, which operates primarily in the eastern part of the country, and Citizens Insurance Company of America, based, as Congressman Rogers mentioned, in Howell, Michigan.

Allmerica ranks 23rd among all property and casualty insurers in the United States. Although we are certainly not among the largest insurance companies, we are strong advocates and supporters of comprehensive insurance regulatory modernization, including optional Federal chartering.

I am here today on behalf of the American Insurance Association, where I am incoming chairman. I appreciate the opportunity to testify this afternoon about the insurance regulatory system both in the U.S. and abroad, and, in particular, AIA's support for optional Federal chartering as a way to make the current State regulatory system more effective and more efficient for all stakeholders.

Mergers and acquisitions, changes in the various financial industry sectors, globalization, technology, and, most recently, the tragic terrorist attack of September 11th, each of these have had a tremendous and very different impact on our industry. Yet with all this change, the insurance regulatory environment has remained largely unchanged since 1945 when the McCarran-Ferguson Act established the principle of congressional deference to State insurance regulation.

For every incremental movement towards greater State regulatory efficiency or uniformity, there are many new State-specific regulatory requirements that result in cost, delay, and frustration for insurers, with little, if any, consumer benefit. AIA fully supports modernizing and improving the State regulatory system, and we continue to work toward that end. However, we also believe that Federal regulation is a more appropriate choice for certain insurers and their customers. Regulatory reform, including optional Federal chartering, will benefit the insurance mechanism as a whole. In particular, it will help the individuals, families, and businesses who rely on property and casualty insurance products for their short- and long-term financial security.

We commend the subcommittee's focus on this topic as part of your broader examination of insurance regulation in the post-Gramm-Leach-Bliley era. The current State regulatory system imposes significant costs on insurers and, ultimately, our customers as well as the economy at large. Statutes and regulations are not uniform, and in many States regulatory actions prohibit insurers from responding effectively to marketplace changes.

Meanwhile, the legal and economic environment in which we operate is changing at a breakneck speed. The bottom line is that consumers ultimately pay more for less adequate risk protection than they would under a more dynamic and fluid regulatory system.

The National Association of Insurance Commissioners has acknowledged the need for a more efficient regulatory system, focusing in on what it has called speed to market. The NAIC's recommendations move in the right direction, but ultimately fall short of a true market-based approach. AIA remains committed to the State reform process, but we urge Congress to move forward with the creation of an optional Federal charter.

There are a number of compelling reasons for Congress to move forward with optional Federal chartering. First, a level playing field is critical to the long-term viability of the insurance industry. The Gramm-Leach-Bliley Financial Modernization Act changed the rules of competition for insurers, banks, and securities firms.

Second, new technologies do not recognize State-specific regulatory barriers. Those barriers make it harder for insurers, agents, and policyholders to get full access to these technologies.

Third, the insurance business is increasingly national and international in its customer-focused and regulatory needs. Optional Federal chartering would let companies and customers choose the regulatory approach that is most suitable for their size and scope of operations.

Fourth, the challenges facing the property and casualty insurance industry are also increasingly national and international in scope. Terrorism, natural catastrophies, fraud, and asbestos litigation are just some of the major issues that our industry faces, but the current decentralized regulatory system lacks the tools to effectively address these issues in a comprehensive manner.

I note this committee's interest in addressing the role of the United States in seeking insurance reforms around the world. The U.S. should continue to play that role, but we also must address our own shortcomings in our current system. Insurers and consumers alike all over the world will benefit from open and competitive markets that give consumers ready access to needed products at competitive prices.

We believe that optional Federal chartering will help achieve that goal. Working with other sectors of the financial services industry through the Financial Services Coordinating Council, AIA has developed a set of principles for an optional Federal charter that would accommodate all lines of insurance. You have in my prepared text an outline of each of these principles. Taken together, these principles assure that the new regulatory system is responsive to the needs of customers and claimants, taxpayers, and the public at large. Through the FSCC, our organizations are also working to develop a single legislative proposal which we hope to release shortly. We recognize that this will be a long legislative process, but we look forward to working with you to advance a bill that would result in a safe, sound, and solid regulatory system.

Optional Federal chartering will bring numerous benefits to consumers and to the public at large. Consumers will save money as the market becomes more efficient and competitive. They will also have more product options. Optional Federal chartering will also enhance the U.S.'s position as a trading partner and address criticisms that we have received from abroad that the current system is protectionist. The changing marketplace at home and abroad makes comprehensive insurance regulatory reform imperative. A new structure will assure a healthy consumer-oriented U.S. property and casualty insurance industry for the 21st century.

We appreciate the subcommittee's attention to this important issue, and later on I will be happy to answer any questions that you all have. Thank you.

Chairman BAKER. Thank you, sir.

[The prepared statement of Robert P. Restrepo Jr., can be found on page 300 in the appendix.]

Chairman BAKER. Our next witness is Mr. Paul Mattera, who is the Senior Vice President and Chief Public Affairs Officer for Liberty Mutual Group on behalf of Liberty International. Welcome, sir.

STATEMENT OF PAUL MATTERA, SENIOR VICE PRESIDENT AND CHIEF PUBLIC AFFAIRS OFFICER, LIBERTY MUTUAL GROUP, ON BEHALF OF LIBERTY INTERNATIONAL

Mr. MATTERA. Thank you, Mr. Chairman.

Mr. Chairman, Mr. Kanjorski, members of the subcommittee, my name is Paul Mattera, Senior Vice President and Chief Public Affairs Officer for Liberty Mutual Group.

Liberty Mutual is primarily a property and casualty insurance company based in Boston with $14 billion in revenue and over 37,000 employees in the United States and in 15 countries. Liberty is the leading provider of workers' compensation insurance in the world. The fifth largest P&C insurer in the United States, and the second largest U.S. based international insurer.

I am here today to express the company's long-held belief that State-based insurance regulation is fundamentally sound and should not be abandoned in favor of a Federal model or dual charter model of regulation.

I have also been asked to discuss the EU model of insurance regulation and to consider what lessons might be learned from the European experience. Let me start by describing the EU model. The EU has significantly liberalized company licensing so that a company licensed in one member country can operate as a branch or a subsidiary in other countries without additional licenses. This so-called passport system is the key feature that sets the EU apart from the U.S. However, like the U.S., the EU has strong preference for so-called host control; that is, the country in which the business is conducted retains regulatory authority.

Even where uniform rules exist, local interpretation can vary widely. Now, the EU has recently abolished rate and product regulation, but financial, accounting, tax, market conduct, and other requirements continue to be applied by the host country. So, the notion of on a single unified regulatory structure has not yet come to pass. Some aspects of the company's operations are regulated by the home country, some by the host country, and both subject to the directives of the E C.

Mr. Chairman, I would like now to make just a few quick points about the EU model and about the U.S. system in contrast. First, the EU model is not a panacea. While there are lessons for the U.S., streamlined licensing, reliance on competitive markets, it is too simple to say that it should be the model for the U.S.

Second, we don't need the EU model to promote global competition. The U.S. system is neither a trade barrier for foreign competitors seeking to do business in the U.S., nor does it prevent U.S. companies from entering foreign markets.

Three, reform takes time. The EU system has taken nearly three decades to get where it is, and it is still changing. Before we abandon the U.S. model, the Congress should send a clear message to the NAIC and to the States that they must accelerate the modernization agenda and complete it within a reasonable time frame or risk Federal takeover.

Fourth, State-based insurance regulation is fundamentally sound. The State system has served consumers and providers well over the last century; however, considerable improvements are needed for the system to meet the challenges of the 21st century. One of those challenges is the expansion of class action and asbestos liability and its impact on the solvency of our industry. State regulators have not been effective advocates in this regard, and their performance will have to improve or the calls for Federal regulation will get louder.

Fifth, Federal or dual charter models are deceptively simple. By promoting uniformity, they imply that all regulatory functions can be managed by a single regulator. But dual regulation, as in the EU, may be closer to the reality where residual markets, guaranteed funds, rate regulation perhaps, market conduct are all left to the States.

Sixth, and last, insurance regulation is inextricably tied to State law. States have the constitutional prerogative to establish liability laws and other reparation systems. Since insurance is so closely tied to these laws, it follows that insurance regulation should remain State-based. Move insurance regulation to Washington, and the underlying reparations laws, workers' compensation, automobile reparations, and so on will inevitably follow.

Finally, Mr. Chairman, I urge the subcommittee to move cautiously as it considers the best model for regulating the property and casualty markets and promoting competition in the 21st century. Thank you.

Chairman BAKER. Thank you, sir.

[The prepared statement of Paul Mattera can be found on page 249 in the appendix.]

Chairman BAKER. Our next witness is Mr. Franklin Nutter, President of the Reinsurance Association of America. Welcome, Mr. Nutter.

STATEMENT OF FRANKLIN W. NUTTER, PRESIDENT, REINSURANCE ASSOCIATION OF AMERICA

Mr. NUTTER. Mr. Chairman, members of the committee, thank you very much. Reinsurance is certainly the most global of the insurance businesses that you will address as part of your oversight hearings regarding insurance regulation. All of the members of our association are either licensed, authorized, or accredited in all U.S. jurisdictions. I am not here today to endorse one system of regulation over another, but, as the committee requested, to address some issues that have arisen in the context of reinsurance regulation.

Reinsurance is effectively the insurance of insurance companies. It serves the purpose of reducing an insurance company's volatility; it has the effect of spreading the risk across the capital markets of the world, and, as this committee is well aware, addresses catastrophe exposures that insurance companies have.

To put reinsurance in its proper perspective, the net reinsurance recoverables by all U.S. property/casualty insurers represents 144 percent of the total property and casualty surplus of all U.S. insurance companies. The NAIC's own statistics show that in the year 2000, there were 3,300 foreign reinsurers that did some business in the United States, although it is clearly heavily concentrated among a smaller number of companies.

Reinsurance is regulated differently than you hear from other parts of the industry. A reinsurance company that chooses to be licensed in the United States is subject to all of the same regulatory requirements for solvency regulation as an insurance company, but reinsurers are not regulated with regard to the rates that they charge or the coverages that they write, largely because those contracts are deemed as written between sophisticated commercial parties. Reinsurers do not have any direct relationship with insurance consumers.

For those companies who choose not to be licensed in the United States, reinsurance is regulated on an indirect basis largely through credit for reinsurance laws, which effectively provide the accounting treatment that is given to insurance companies for their use of reinsurance. Reinsurance companies that are not licensed in the United States and choose to do business on that basis, collateralize their obligations through trust funds, letters of credit or other forms of security to make certain that reinsurance is collected.

The issues that I would like to comment on include credit for reinsurance. There have been some at the National Association of Insurance Commissioners forums suggesting that the collateral requirements imposed upon nonauthorized reinsurers should be reduced. The U.S. insurance market is heavily dependent on a global reinsurance market, and yet insurance regulators cannot be expected to understand the accounting or the regulatory schemes throughout the world. Regulators have confidence in the collectability of reinsurance largely through the requirement for collateralization of the non-U.S. reinsurance obligations. It is difficult to comprehend how the U.S. system could impede competition based upon the statistics that I gave you earlier; and, indeed, if the Congress is to consider an optional Federal charter or minimum Federal standards, our association would urge the Congress to incorporate a strong credit for reinsurance regulatory system similar to the NAIC's model and regulation.

I have commented in the text of my testimony on the inconsistencies among the State systems, often referred to by other panelists, regarding the costs and inefficiencies of dealing with a multistate system. When you are dealing with a multi-state, indeed global, insurance part of the system, such as reinsurance, there is particular concern about the extraterritorial application that some States apply their laws to insurance and reinsurance. It is important that the difficulty in complying with States is recognized in a system where States do not respect the laws and regulations of the other States.

We have also commented in the written testimony about an issue that is referred generally as mutual recognition. The laws addressing regulation of reinsurance in various countries are quite varied. There is no globally recognized method of conducting reinsurance regulation, yet some have suggested that the States of the United States should recognize other countries' regulatory systems, and thereby relieve insurance companies who do business in the United States from the licensing or collateral requirements that would be imposed upon them in the United States. We have opposed that initiative largely because we feel that it cannot proceed until there is a more uniform international accounting system; until the States recognize the regulatory system among themselves; and, third, that judgments entered into in the United States are recognized and enforced abroad.

The last issue that I did want to raise is receivership. Insurance companies that are insolvent or have financial problems are not subject to U.S. bankruptcy laws; they are subject to insolvency laws and receiverships on a State-by-State basis. Generally we find those laws to be archaic and inefficient. Often reinsurance recoverables are the principal asset in those receiverships. We have participated in the drafting of a uniform national receivership law. If the Congress were to consider a national system or minimum standards, we would strongly encourage a uniform national receivership system be implemented.

And, lastly, I am not here to endorse one system over the other, but to say that there are a number of alternatives available for the future structure of insurance and reinsurance regulation, including minimum Federal standards, and that we believe that it is incumbent to find that critical balance between the cost and efficiencies of the system and a competitive and secure regulatory environment for reinsurance. Thank you very much.

Chairman BAKER. Thank you, Mr. Nutter.

[The prepared statement of Franklin W. Nutter can be found on page 286 in the appendix.]

Chairman BAKER. Mr. Mattera, in a portion of your written testimony you submitted, you made a comment with regard to the system and its effectiveness in Illinois that I read as being a favorable view of that system. Is there legitimate reason, in your mind, for the Congress not to act on some Illinois-like model, given the length of delay we have encountered with State-to-State regulatory enhancements? Can you comment?

Mr. MATTERA. I would be happy to comment, Mr. Chairman. The Illinois system certainly is probably the best example among the States of one which promotes open and competitive—an open and competitive market. We think the Illinois system as it relates to the commercial lines is one that is achievable through a State-by-State attempt at reform. And, indeed, both through NAIC leadership and hard decisions made by State legislators in a great number of States over the last 2 or 3 years, a great deal of progress has been made in opening up, if you will, the commercial lines to a more competitive market.

Our sense—our company's sense is that there is resistance to the notion of the Illinois model as it relates to the personal lines. I question whether—and, with all due respect, whether an open and competitive rating system like Illinois is one that is achievable in Federal law, which is what has led us to question, you know, the utility and the viability of either a Federal or an optional charter approach. A significant reason for one's support for either of those approaches, it seems to me, is the opportunity to engage in a more competitive market, and we have some serious misgivings that it is unlikely to be achieved at least with regard to the personal lines.

Chairman BAKER. Commercial lines, possibly; personal lines, probably not.

Mr. MATTERA. Is probably not.

Chairman BAKER. Is your view? Thank you.

Mr. Restrepo, you also have made comments about the Illinois model. Do you have a different view, or do you think that it is an advisable direction for us to explore?

Mr. RESTREPO. We clearly think the Illinois model is the best practice and clearly one of the best State regulatory systems that we have encountered, both within my company and representing the AIA. To the extent that that kind of model is adopted nationally, it would certainly be an improvement, but it really doesn't get us where we would like to see the regulatory system move eventually. And we think, given the changes in the industry as companies become more focused on regional sectors, on specific lines of business, workers' compensation, let's say, as companies become more specialized, they are going to want choices regarding the regulatory system that would best meet the needs of their shareholders and their customers, and which is why we are strong advocates of the Federal option, Federal charter option.

Chairman. BAKER. In exploring this, I don't know if you are in a position to answer this particular question, but as it relates to your company's marketing in Illinois and the competitive environment in which you operate, is it your opinion that Illinois consumers enjoy a broader array of product at a better price as a result?

Mr. RESTREPO. They clearly enjoy a better price. And probably one of the single greatest or single—probably the best characteristic of the regulatory system in Illinois is it is pretty free; companies are free to charge what they think they need to charge to both compete and make a profit. So, clearly, from a rate regulation standpoint it is very attractive, and the consumers in Illinois benefited, contrasted with States that we do business with, unlike GEICO in New Jersey and Massachusetts where, combined, New Jersey and Massachusetts represent almost 15 percent of our premium volumes, and those two States probably have the highest automobile insurance rates in the country.

Chairman BAKER. I had an omission on my part. I meant to ask the prior panel if it would be advisable, in light of the decision to withdraw from offering product in New Jersey, if there were an alternative method to allow you to enter the New Jersey market, wouldn't that really be beneficial to New Jersey automobile drivers? It seems to me that the solution there is more competition and less regulation.

Mr. RESTREPO. I agree 100 percent.

Chairman BAKER. And, however we can provide access to product is generally beneficial to consumers.

Mr. RESTREPO. Consumers in both States are suffering not only from a lack of markets, but a decreasing number of markets as companies either go bankrupt or decide to exit the State. And any kind of regulatory system that will promote more competition would make New Jersey, and Massachusetts a more attractive place to do business.

Chairman BAKER. Thank you.

And one last quick one. Mr. Mattera, given your perspective on this, the NAIC has—I can say, I have sent some telegrams—independently indicated an interest in seeing a time line, you know, a direction toward uniformity, not necessarily just reciprocity. But even with our best effort, they have some areas where they have enjoyed more success than others; but when it comes to market conduct examination reform, they really lag behind there more so than anywhere else. Why do you think that is? What is the problem?

Mr. MATTERA. I think the short answer with regard to market conduct is that they have simply taken it up later in the process. It has been I don't want to say a lower priority, but in terms of trying to tee up issues in some sequence, it has been the third or fourth issue in that sequence. So I don't know that it has been the most difficult problem to deal with; I think it is one that they have simply chosen to deal with a little bit later on.

Chairman BAKER. If that is the case and it is only a timing issue, if we are going to get through the entire list, and let's just assume we agree on what the list is, how many years are we talking in order to get the job done?

Mr. MATTERA. Of course, I don't know the answer to that. I would like to make this comment, though: I mean, we have seen, and there has been some questioning to this effect, that when the States—when their collective feet are held to the fire, when the Congress is forceful with respect to the—you know, the accountabilities—and I think agent licensing is a perfect example of that—there has been good response. Now, some can argue about—I think someone said 70 percent of the market is—you know, is there, but 30 percent isn't, and we can argue about how you define success, but I think objectively, you know, 45, 46, 47 of the States have come in line.

I mean, there is a—and not to pander—there is a very important role for this committee and for the Congress in identifying the kinds of change that need to be made so that insurance markets in this country across all 50 States operate more smoothly, more openly, with more transparency, competitively to identify what those areas of change are and then establish some time line within which the States have got to act. And if they don't act in that time, then I think, you know, the gloves come off. And there are steps—and I don't presume to suggest to you what they may be, but then there is perhaps—there are actions that the Congress can take, whether it is Federal standards or preemption or otherwise.

But as I said earlier in my opening remarks, the EU has arrived at what some have described as, you know, a good example of open market regulation. I would say they are not quite there yet; but even so, it has taken them nearly three decades.

So how much time, Mr. Chairman? I don't know. But I think without some kind of fixed date in the future, we may not have the kind of change that all of us, I think, at this table would want to see.

Chairman. BAKER. Thank you, sir. My time has expired.

Mr. Kanjorski?

Mr. KANJORSKI. That would be about 2032? I don't think many members of the committee will still be here, and I am not sure how much interest the Congress will have in insurance at that point.

Since both of you have your principal headquarters in Massachusetts and you differ so widely on this issue, do you want to tell me why? What is the distinguishing reason? Why are you so much in favor, and why are you so much opposed to it?

Mr. RESTREPO. Well, maybe I will go first. Even though we are only separated by 50 miles, we have two very different companies, two very different marketing plans. And I can't speak for Liberty Mutual's plans. We compete with them in some markets, but they are a much bigger company than we are. So we have different—.

Mr. KANJORSKI. But you sell the same type of insurance.

Mr. RESTREPO. But we have different markets. One of the markets that we are looking to get into, our traditional market is, as a regional company, in Michigan and the Upper Midwest and then New England primarily. We do some business in the Southeast. But increasingly we are looking to enter a market that we define as sponsored, where we go to large employers or associations, like the American Automobile Association, to sponsor our product to their employees or members.

So one of the restrictions we have as a regional player is trying to enter new States. And so we would like to have the option—to support our marketing plans as we venture into that market, we would like to have the option of considering a different regulatory environment that would make it easier for us to enter that kind of a market and also to enter new States if we choose to expand our regional presence.

Mr. KANJORSKI. And you are almost nationwide at Liberty, and you say it is easier to stay at a State level.

Mr. MATTERA. Well, we are. We are countrywide—I hate to use the word nationwide. We are countrywide.

I guess there are three reasons that I can offer. One is philosophical. And it is hard to sort of back away from what is a philosophical belief; that because the underlying reparation system is State-based, the regulatory system must itself remain State-based. There is that philosophy that guides a lot of our thinking. That is first.

Second, perhaps more practically, Liberty is primarily a large-risk underwriter. I mean, we are one of a handful of insurance companies in this country who insure the Fortune 500 risks, AIG, Travelers, Liberty. There aren't very many who really play in the market. That is essentially a deregulated market. And even in the middle commercial market, there has been significant movement over the last 2 or 3 years, as I commented earlier, in the direction of more competition in price and product.

So there is—we see on the commercial side more progress being made. That may not be as visible to some companies; it is quite visible to us.

And then, thirdly, we are a substantial player in the personal lines market. Now, not like Mr. Nicely, who I think said that GEICO has 5 percent of the personal lines premium revenue in the country, Liberty is at 1 or 1-1/2 percent. So, we are significantly smaller, but we are substantial, and in that area we feel as though we have been reasonably successful, sort of slugging it out in States, regulator by regulator, forcing the issue, getting the rate level, getting the policy changes, able to conduct our business. It takes time, it is inefficient, it adds cost, but at the end of the day we have managed to get through that process reasonably well.

And so those are the best answers that I can give you, Mr. Kanjorski, as to why we are rooted in the notion that the State-based system ought to remain as such.

Mr. KANJORSKI. And both of your companies are writing both in Massachusetts and New Jersey, unlike some of the others?

Mr. MATTERA. Well, we are writing in New Jersey, and we are certainly writing in Massachusetts, and we are writing in all of those States that are held out as the parade of horribles. And I am not here to tell you that it is just hunky dory for us. It is not. We lost $100 million in the year 2000 in New Jersey, it is a lot of money, but we think we are turning the corner in that State.

Mr. KANJORSKI. Is that being subsidized by—.

Mr. MATTERA. It is a fair question.

Mr. KANJORSKI. —Pennsylvania payers?

Mr. MATTERA. At the end of the day, there are implicit subsidies in the insurance business. I don't think one can walk away from that. So the answer to your question, I suppose, is yes.

Mr. KANJORSKI. What happens if the Congress takes no action, and the State insurance commissioners feel the pressure is off of them, and we are here again 5 or 8 years from now?

Mr. MATTERA. I mean, you are asking me. I think that is the absolute worst possible result.

Mr. KANJORSKI. Someone said it should have been done 15 years ago; Mr. Gasper, in his testimony. And I don't know how long Mr. Baker is here, but I am here 18 years, and it is the first time that I recall testimony regarding any Federal involvement with the charters. As a matter of fact, it used to be considered a poison pill on the Hill to mention Federal charter and insurance in the same sentence, but now we are being inundated by some companies.

Mr. MATTERA. But if you go back to, I am thinking, the 103rd Congress, Mr. Dingell, the notion of failed promises and the need for rejuvenated solvency regulation within the insurance industry, the result of that cajoling, the result of that effort was, you know, an accreditation program developed at the NAIC, sold to the States, enacted by the States, which did elevate considerably—and I don't know if there are many people who would argue against this notion—considerably elevated both the tools by which State regulators measure financial condition and act on companies that are failing, and also the standards, through risk-based capital standards and otherwise. And so if there is a success of State regulation, I think it is fair to say it was—it is the accreditation process, and that was a direct result of Federal threats to take over that aspect of the insurance regulatory structure.

Mr. KANJORSKI. I just have one additional question. Mr. Nutter talked about the national scope of receiverships or conservatory operations. Do you two gentlemen agree that we should have a national standard on that, or should we leave that to the States, if we come out of nothing else, to a national standard on the receiverships?

Mr. RESTREPO. You are asking me? I think that would be a step in the right direction, sir.

Mr. MATTERA. I guess it would be inconsistent for me to sort of hold the view that a national standard is something that Congress should jump to at this time. I think, consistent with my earlier statement, I know we would prefer to see the Congress's other means to achieve the same result.

Mr. KANJORSKI. Okay.

Mr. Chairman, my time has expired.

Chairman BAKER. Thank you, Mr. Kanjorski.

Mr. Ney?

Mr. NEY. Thank you, Mr. Chairman.

I wanted to pose the question, Mr. Restrepo, to the AIA. Looking at State insurance guaranty funds that exist, I think we can recognize that most of those funds have done a good job over a period of time. Now, either in your proposal or the gentleman from New York, I think that it would be the hope that even if an entity goes in a State charter or Federal charter, it could still have the backing, inclusion of those State-guaranteed funds; is that correct?

Mr. RESTREPO. That is correct. Our proposal requires no change to State-guaranteed funds, to State premium taxes, or to State residual market mechanisms.

Mr. NEY. Let me pose a question based on that. So, let's say that I am the head of a State guaranty fund, and for some reason, the new Federal regulatory system is set up, I feel that it is inadequate, or just so choose to say that you are chartered with the Feds, now you are on your own, you are out of our guaranty fund. Now, I understand the repercussions of that for a State; but what if that scenario happened, and that happened in several States? Would the Federal then have to set up a guaranty fund?

Mr. RESTREPO. Not necessarily, sir. I think that is a detail, obviously, that would —.

Mr. NEY. That is a big one.

Mr. RESTREPO. That is a big detail that needs to be addressed in the legislation. I think, from our standpoint right now, we feel that the State guaranty funds should continue to operate as they are currently operating.

Mr. NEY. I am just trying to think of—you know, we can think of any scenarios. I am just trying to think of a scenario from a State regulator's point of view, and they can't regulate you, but you are in the guaranty fund, and they feel something just didn't go as it should, and then they could kick you out of that. And I just wonder where that leaves us. It is a very valid item, I think, that has to be looked at.

Mr. RESTREPO. I agree.

Mr. NEY. The other question I have that I think is interesting for Mr. Nutter, isn't it true that reinsurers are largely unregulated under State laws?

Mr. NUTTER. Reinsurance rates and the forms or the coverages, the contracts written between insurers and reinsurers are generally not regulated by the States; but an insurance company or a reinsurance company that is licensed in the United States is subject to all the same solvency standards, laws, holding company statutes as insurance companies.

Mr. NEY. So wouldn't a Federal—if we created a Federal regulator—be able to tighten the regulations then nationwide on, for example, you know, your type of industry?

Mr. NUTTER. We have no position in favor of a Federal national system, but it is quite clear that reinsurance tends to be—because of the global nature of it, tends to have issues that transcend State borders and, in many cases, transcend national borders. The State system is an awkward system, if you will, to deal with a business that is writing contracts on a multistate and often a multinational basis.

Mr. NEY. So you basically are disputing, then, that you are not—that you are free from State regulation?

Mr. NUTTER. There is no question that a reinsurance company licensed pursuant to State law is subject to all of the same solvency regulatory standards other than rate and form regulation. Much of the U.S. reinsurance market is written by non-U.S. reinsurers who are subject to regulation only through the collateral requirements. They fund their obligations through letters of credit or trust funds or other funds withheld.

Mr. NEY. One other question I had real quick. What is the angle of the WTO? I saw that in one of the testimonies. I understand what Europeans have been talking about. Am I to gather that there will be eventual filings against us at the WTO? Somebody mentioned WTO in their testimony.

Mr. MATTERA. I don't know that I did, but I did make some references, I was asked to, to the EU and the regulatory model there. And I did make some further comment. Maybe I can just expand on it.

Some have suggested that the 50-State regulatory system is a trade barrier because it is inefficient. Now, as ugly as what I am about to say next sounds, I think it is the truth. An inefficient system per se is not a trade barrier so long as it applies equally to all who seek to do business in that market. That is not to apologize for what is admittedly an inefficient system in the U.S., but I don't see the argument that somehow, unless we create a single regulatory structure, either an optional charter or pure Federal regulatory structure, somehow we are going to be in violation of WTO or imposed trade barriers. I don't see that argument at all, if that is where you are going.

Mr. NEY. I just read it.

Mr. NUTTER. It was in my testimony that the WTO was mentioned because some of these issues about collateral requirements have been considered by the International Association of Insurance Supervisors, by the NAIC, and there have been references at the WTO for these kinds of things; nothing in the trade barrier level, but in the context of questions about whether or not any of our regulatory requirements in the reinsurance area would be considered anticompetitive or create barriers, as Mr. Mattera says.

Mr. NEY. Thank you.

Chairman BAKER. Thank you, Mr. Ney.

But that inefficiency does create a higher premium cost if you can get product. And in some cases where the regulatory barrier is so bad—New Jersey—some people don't even go. So I think that is the economic reality.

Mr. Bachus?

Mr. BACHUS. Thank you.

First of all, Mr. Restrepo, what Mr. Ney was saying about the LaFalce—all these proposals I have seen don't allow a State to regulate a federally chartered property and casualty insurance company. And I think it is sort of Pollyanna to think that the States are going to allow a federally chartered company to participate in their State insurance guaranty fund. I think clearly constitutionally they can say, you can't participate; we can't regulate you, you can't participate. And in that case I don't see any alternative to having a Federal guaranty fund.

Now, do you believe that constitutionally we can take the States out of the regulatory business and at the same time require the States to supply an insurance guaranty fund?

Mr. RESTREPO. I think, number one, we are—a company that chooses the Federal charter as an option is still controlled by State laws.

Mr. BACHUS. But not—.

Mr. RESTREPO. Regulatory, as it relates to market conduct and financial solvency, would change, but we would still be using—a company that chooses that option would still be using the same statutory accounting principles that most insurance companies operate under.

Mr. BACHUS. But I think clearly the State could say, you can't participate if you are not subject to market conduct rules.

Mr. RESTREPO. As I understand it, that would be a State's prerogative.

Mr. BACHUS. That is what I am saying, it would be their prerogative.

Mr. RESTREPO. But as a practical matter, even though a State—from my perspective, even though a State wouldn't be regulating, let's say, the financial solvency, they would still have access to the information to make an informed decision whether or not they want an individual company to participate in it.

Mr. BACHUS. They would. And if they decided that the Federal regulation was loose, whatever —.

Mr. RESTREPO. But in the best interest of the consumers in that State, I think most informed State regulators would want to have the maximum amount.

Mr. BACHUS. I think they want the fees that are generated, too.

Mr. RESTREPO. Well, and they want the participation in the fund. And if they had a solvent company —.

Mr. BACHUS. But they wouldn't be able to regulate; so how would they be able to determine?

Mr. RESTREPO. They would be able—.

Mr. BACHUS. I am just saying—.

Mr. RESTREPO. —to have access to the information to make a decision whether or not they wanted company A or B.

Mr. BACHUS. But would they have any power to do anything about it when they got the material?

Mr. RESTREPO. I imagine they could kick the company out.

Mr. BACHUS. Well, that would be State regulation now.

Let me go on to something else. How many people are employed in the various States in regulating insurance companies? Do you know how many? How many employees of the State insurance regulators?

Mr. RESTREPO. I do not know.

Mr. BACHUS. Anybody got a figure?

Mr. MATTERA. Well, I mean, it varies wildly from State to State. You know, whether there are sort of relativities associated with size of population or not I can't say. But Texas probably has in excess of a thousand employees regulating insurance. California probably well over that. Massachusetts probably a fewer than a hundred. So it varies widely.

Mr. BACHUS. From maybe 100,000 nationally—.

Mr. MATTERA. Oh, I see. In total, I don't know. But—I don't know.

Mr. BACHUS. When we have Federal regulation, have a Federal—we have Federal employees regulating. That would be in addition to the State, to the employees at the State regulators. Now, somebody has to pay for that regulation.

Mr. MATTERA. That is right.

Mr. BACHUS. Doesn't that add to the cost or couldn't that?

Mr. RESTREPO. Well, under our proposal, companies that would choose a Federal option would be paying the freight of the new regulatory system, so the taxpayers would not be hurt.

Mr. BACHUS. So they would actually pay for the Federal regulations.

Mr. RESTREPO. That is correct. They would pay for their choice.

Mr. BACHUS. You know, for property and casualty insurance particularly, don't State regulators often play a big role in seeing that claims are paid? I mean, that has always been my observation.

Mr. RESTREPO. State regulators are responsible for market conduct. One of the areas that they get involved with is, obviously, responding to complaints about—from consumers who don't like the way a claim was—.

Mr. BACHUS. So you would—the Federal regulator that would be formed would actually insure that claims were paid properly?

Mr. RESTREPO. That they—yes, that they—that claims were being handled in compliance with—.

Mr. BACHUS. With State law?

Mr. RESTREPO. —with State law or according to the Federal regulations.

Mr. BACHUS. So you would have a Federal regulator that would be interpreting insurance contracts under the law of the pertinent State. So the Federal regulators would have to interpret the law of 50 different States and the territories?

Mr. RESTREPO. No. They could be handling the complaint. A claim rep would be settling a claim in compliance with the local— .

Mr. BACHUS. Well, you know, even to determine whether a valid claim is being asserted, you have to go to State law to see whether that is a valid claim.

Mr. RESTREPO. That is correct.

Mr. BACHUS. So they would—you would have a Federal regulator that would be having to interpret the law of all 50 States, and if there were a dispute it would have to be resolved in the State court. So your Federal regulator could be involved in litigation in all 50 States and yet the federally chartered insurance companies would have to pay all the freight for that?

Mr. RESTREPO. Yes.

Mr. BACHUS. It could be pretty expensive.

Mr. RESTREPO. For the companies that exercise that choice, yes.

Mr. BACHUS. I have never had a—I have never—of course, I am a Congressman, but I have never had a constituent complain to me about the lack of claims being paid, so I don't see that there is a problem. So, you know, from my standpoint I have got to wonder why I want to fix a system, at least in payment of claims, that seems to be functioning well.

Mr. RESTREPO. Well, we are in the business, obviously, sir, of paying claims; and that is good to know.

Mr. BACHUS. That is sort of—when the public deals with you, that is—basically, their interest is seeing that their claims are paid, paid properly and adequately paid.

Mr. RESTREPO. That is correct.

On the other hand, though, there are consumers that are looking or would like to entertain new products, and they see new risks that they would like to insure. The thrust of our proposal is really to accelerate our ability to respond to those emerging needs.

Mr. BACHUS. I am just saying I don't hear customers out there saying their claims aren't being paid.

Mr. RESTREPO. That is good to hear.

Mr. BACHUS. And you agree, I think.

Mr. RESTREPO. I think we have a pretty good reputation.

Mr. BACHUS. That is not a big problem. In a nation full of problems, that doesn't seem to be a problem. Yet we are going to create a national regulator charged with—one of their duties is to see that claims are paid and replace a system that apparently is working quite well.

Mr. RESTREPO. That is one aspect of the regulatory authority. Another, though, would be rate regulation and product regulation, I think, as we have mentioned.

Mr. BACHUS. I understand the product part. I understand that. But couldn't we fix that by having Federal mandates to the States for uniformity with regard to approval of products and et cetera?

Mr. RESTREPO. We could.

Mr. BACHUS. That could take a much smaller federal bureaucracy than one that has to monitor every claim, has to interpret every contract.

Mr. RESTREPO. We could, but our most recent experience even with the NARAB is, as we have heard, only 70 percent of the people are really—the consumers have been affected.

Mr. BACHUS. Well, some of those deadlines aren't here yet, though. So with NARAB—.

Chairman BAKER. Thank you, Mr. Bachus.

Dr. Weldon.

Dr. WELDON. Thank you, Mr. Chairman.

Mr. Restrepo, how do you think Florida could benefit from an optional charter, Federal charter, particularly with the States' increased risk for natural disasters, specifically hurricanes?

Mr. RESTREPO. Well, one of the biggest risks, obviously, are natural catastrophes. Natural catastrophes, as you are intimating, don't know State boundaries.

There have been efforts under way over the past couple of years, both on a national and a regional basis, particularly in the Southeast, to establish pools, risk pools; and one of the biggest impediments is getting the agreement of State regulators who have differences in the statutory authority that is granted them, differences politically. Some are elected. Some are appointed. Being able to get States with common interests, such as States bordering Florida and the Southeast, to come up with alternative risk transfer mechanisms that certainly Florida consumers have, they are very difficult to move through a State-regulated process.

I think having a Federal charter as an option would allow States—would allow new companies to come into Florida and not be subject, obviously, to Florida regulatory restrictions and be able to offer products that perhaps aren't offered right now. Certainly under different terms and conditions as well.

Dr. WELDON. Thank you.

Mr. Nutter, earlier in the year we heard a lot from the insurance companies about the post-9/11 status of their industry. I don't know if we have heard anything about the reinsurance market. If we did, I don't recall. Did that adversely affect the reinsurance industry? And what is the status of the reinsurance industry right now, post 9/11?

Mr. NUTTER. Thank you for the question, Dr. Weldon.

It is estimated the reinsurance market, both domestic and foreign market that serves the U.S. Market, will probably pay two-thirds of the claims that arise out of the September 11 disaster. If the loss estimates are between 40 and $70 billion, you can make your own calculations. So you can see it was an enormous financial impact on the reinsurance markets.

Having said that, I am not aware of any reinsurer that has been threatened for its solvency for that; and indeed I think the market has responded extremely well to pay for the catastrophe loss associated with September 11th.

Dr. WELDON. Has there been any impact on capacity, or are the demands of insurers for reinsurance being adequately met?

Mr. NUTTER. The impact on capacity has largely been limited to issues about coverage for acts of terrorism.

With respect to capacity for other kinds of risks, such as natural catastrophe risk, it does not appear that that has affected the capacity. Indeed, there were a number of new insurers and reinsurers that were begun after September 11 believing that there was a market opportunity and capital wanted to be in the market. Reinsurance rates have risen fairly dramatically. Capacity appears to be plentiful, with the exception of acts of terrorism where there clearly are some limitations in the reinsurance market.

Dr. WELDON. So insurance companies wanting to get reinsurance to cover natural disasters are not facing any kind of difficulty in obtaining reinsurance.

Mr. NUTTER. Perhaps you have two primary companies sitting here who probably should answer the question.

I would say that, indeed, property catastrophe reinsurance rates have risen.

Dr. WELDON. So there is plenty of capacity, but rates have gone up. Is that what you are saying?

Mr. NUTTER. Rates have certainly gone up.

Dr. WELDON. But aren't those two things related? As there is more capacity, rates tend to come down.

Mr. NUTTER. Generally, that has been true. If you look at Hurricane Andrew and the subsequent Northridge earthquake, indeed insurance rates rose. Capacity seemed limited at the time. The market responded over time. Indeed, you now have a highly competitive market with a reasonable amount of capacity.

As you know, Dr. Weldon, we believe that there still is a need for a Federal role with respect to catastrophe capacity dealing with both natural disasters and for acts of terrorism; and we commend you for your leadership in that regard. There is not sufficient capacity to deal with costs associated with acts of terrorism. There is no question about that. Indeed, for major catastrophic events there are limitations in the reinsurance market to deal with the kind of hurricane or earthquakes that might hit a major metropolitan area. A Federal role in both areas would be very important.

Dr. WELDON. Do either of you, Mr. Mattera or Mr. Restrepo, want to add to that at all?

Mr. RESTREPO. The only thing I—go ahead.

Mr. MATTERA. No, I would just like to maybe underscore an issue which has perhaps recently become more apparent; and that is the very urgent need for buyers of worker's compensation insurance and providers of worker's compensation insurance to have in place—for the Congress to put in place a Federal backstop at a high level for a short period of time. Because it is becoming increasingly apparent that those employers with large concentrations of employees, particularly in the urban core of this country, it is—the providers are exposed. Those who are self-insuring that risk are exposed. Ultimately, the economy is exposed.

Certainly, the House has done its part; and we are all focusing our attention, of course, now to the Senate.

Mr. RESTREPO. Two examples, Congressman, that I would cite regarding the impact of reinsurance on the U.S.

Number one, from the capacity standpoint, we got the same limits, but we don't have terrorism coverage, and we are paying 30 percent more. That is just a microcosm. I can't say that is an average of everybody.

On the second issue, I would raise, just to support what Mr. Mattera just mentioned, we have also changed our underwriting attitudes about larger companies. We don't write many of them, but people that employ more than a hundred people or in our case even 50 people at one site, we are withdrawing capacity because we don't—we are not able to find reinsurance for that kind of exposure as a result of the lack of Federal backstop.

Dr. WELDON. I just had one quick follow-up for you, Mr. Mattera. In your opening statement you defended the State regulatory system, and then in response to I think it might have been Mr. Ney's questioning you acknowledged that it was inefficient. Those are the words that you used.

Mr. MATTERA. Uh-huh.

Dr. WELDON. I am sorry.

Mr. MATTERA. And you think there is a contradiction in there some place, do you?

Dr. WELDON. Yes. Can you kind of explain to me why you would come before our committee and defend an inefficient system?

Mr. MATTERA. I am not defending.

Dr. WELDON. I am not trying to put you on the spot. It is just you said it.

Mr. MATTERA. No, it is a fair question. We prepared—the company prepared a white paper some months ago called, The Case for State Regulation, and when it was first drafted it had a different title. It was called, In Defense of State Regulation. We thought about that, and we thought that there was actually a subtle but important distinction between defending the State system and trying to make the case for the State system.

Fundamentally, the State insurance—the State-based insurance regulatory system is sound. But it is inefficient. There is a great deal of change that must occur.

I don't think I need to elaborate all of those points unless we have got another hour, and I would be more than happy to do that.

Dr. WELDON. Well, the impression I get is that it is an inefficient system but that carriers like you have adapted well to that inefficient system and that there is really no gain to changing the system because you have already accommodated to it.

Mr. MATTERA. That would be a large overstatement.

The number of truth in there I think, though, is that the system is solvable to some degree. That is not to say that there aren't significant changes.

You see, there has been a lot of discussion in the first panel and this one about uniformity, the notion that, you know, we are not going to get to where we want to go unless we have a set of regulations across the 50 States that are uniform one to the other. We don't believe that uniformity is the Holy Grail in insurance regulation.

Dr. WELDON. Uniformity doesn't necessarily mean greater profitability, correct?

Mr. MATTERA. Put profitability aside. I mean, just conceptually, philosophically. I mean, uniformity —I mean, obviously, profitability is the end game for a provider of insurance. But service to customers, staying in business, I mean, all of that is equally important.

My point is only that one can have what is, you know, sort of inherently inefficient systems that are effective and don't need to be replaced. Where the inefficiencies become so great as to sort of thwart the proper carrying out of the business and service to customers, then change needs to take place.

I think we are there today. We need to make changes. The system is too inefficient. But I don't think that inefficiencies, per se, are the reason for change, so long as the rules are effective. They are not effective across the vast number of States, and change does need to be made. So I am not defending the system. I am defending the notion of a State-based regulatory structure.

Dr. WELDON. Well, my time has expired. It has been a very interesting hearing. Thank you, Mr. Chairman.

Chairman BAKER. Sure.

Mr. Bachus, you had an additional question.

Mr. BACHUS. Thank you.

I think I would also endorse, you know, Federal promotion of State efficiency and, in some cases, I would say uniformity, too. But let me—Mr. Restrepo, let me ask you this question. What is your projection for the number of people that would be employed by the Federal insurance regulator that you want to create, number of people that would be employed?

Mr. RESTREPO. Sir, I wouldn't hazard a guess. I don't know.

Mr. BACHUS. It could be any number, couldn't it?

Mr. RESTREPO. Yes.

Mr. BACHUS. I wonder if anybody, you know, in proposing this if they have thought through how many employees would be created, how big this agency would have to be. Do you know of anybody that has done any study on that?

Mr. RESTREPO. No, we haven't.

Mr. BACHUS. And whether those employees would be in addition to or in lieu of those folks back there in the States that are regulators?

Mr. RESTREPO. I think it would be certainly a company choosing a Federal option, since they are paying the freight, would have an incentive to encourage a system that wasn't only effective but obviously efficient and—.

Mr. BACHUS. But you—it wouldn't be the companies that would be in charge of how many people worked at the regulator.

Mr. RESTREPO. No, that is true. But to the extent that—.

Mr. BACHUS. You know—.

Mr. RESTREPO. Obviously, in the company's best interest to have a system that was not overstaffed.

Mr. BACHUS. I would be interested in that.

Mr. LaFalce has brought forth this legislation. I would be interested—he is not here. I would be interested in asking him what he envisions as far as the number of employees that would be needed.

Mr. Nutter, let me—.

Mr. KANJORSKI. Maybe I should take a little opportunity on that. Probably no additional employees like the Department of Homeland Security will cause now additional employees.

Mr. BACHUS. Let me ask just the one final—.

Chairman BAKER. I am sensing meltdown, but go for it one more time.

Mr. BACHUS. Mr. Nutter, I mean, am I right that reinsurers are largely unregulated by the States today, right?

Mr. NUTTER. Mr. Bachus, a reinsurance company, including all the members of my association, are licensed in the United States by a State or are accredited. They are all subject to all the same financial reporting solvency standards and the holding company statutes as any other insurance company.

Mr. BACHUS. Do they have separate rules for reinsurers?

Mr. NUTTER. With regard to licensing and solvency regulation, none whatsoever. With the respect to a non-U.S. reinsurer, access to the reinsurance market in the United States is achieved through collateral requirements, trust funds, letters of credit. It is an optional system.

Mr. BACHUS. I just don't—I have never known of much State regulation of reinsurers, I mean, other than your licensing; and I am not saying that is bad.

Mr. NUTTER. No, I understand that.

Just to clarify that, Mr. Bachus, the real distinction between the insurance market served by these two companies and the reinsurance market is that the reinsurance market is a competitive market with respect to rates and the coverages because it is a market between commercial entities. You don't have a regulatory structure that looks at rates and forms as you would in the primary insurance industry.

Mr. BACHUS. But, you know, I guess what I am saying, if you created a Federal regulator, then there would at least be potential there to tighten regulatory oversight on reinsurers, which I am not sure is needed, but I certainly—.

Mr. NUTTER. Well, certainly you would want a system in place that had a solvency oversight system, much as you have at the State regulatory level, and a system that dealt with the credit.

Mr. BACHUS. Are the States doing a good job of that today?

Mr. NUTTER. The States have actually done a very credible job with regard to credit for reinsurance. I think Mr. Mattera referenced the House Commerce Committee hearings of the late 1980s, early 1990s that did, in fact, generate an enormous amount of State legislative activity dealing with credit for reinsurance statutes; and indeed there have not been the kind of solvency issues that we saw in the 1980s that gave rise to these hearings.

Mr. BACHUS. So you don't see any need for any additional regulatory oversight?

Mr. NUTTER. At the Federal level?

Mr. BACHUS. Yes.

Mr. NUTTER. Mr. Bachus, our testimony really has been if you are going to create the option, here are issues that should be addressed.

Mr. BACHUS. But you don't see a need for any, do you?

Mr. NUTTER. We are not here to promote either system. If the Congress chooses to do that or to create national standards for State regulation—there are just certain features we think are important.

Mr. BACHUS. Thank you.

Chairman BAKER. Thank you Mr. Bachus.

Mr. Kanjorski.

With that, I want to express my appreciation to you. It has been a productive hearing today. We certainly do appreciate your comments.

The record will remain open should you choose to make additional comment or forward further information for the committee's consideration.

Thank you very much, and our meeting stands adjourned.

[Whereupon, at 4:26 p.m., the subcommittee was adjourned.]

INSURANCE REGULATION AND COMPETITION FOR THE 21ST CENTURY

Tuesday, June 18, 2002

U.S. House of Representatives,
Subcommittee on Capital Markets, Insurance,
and Government-Sponsored Enterprises,
Committee on Financial Services,
Washington, D.C.

The subcommittee met, pursuant to notice, at 2:00 p.m., in Room 2128, Rayburn House Office Building, Hon. Richard H. Baker [chairman of the subcommittee] presiding.

Present: Representatives Baker, Ney, Gillmor, Weldon, Biggert, Ose, Rogers, Kanjorski, Bentsen, Maloney of Connecticut, Sherman, Inslee, Shows, Ross, Grucci, and Lucas of Kentucky.

Ex officio present: Representative Oxley.

Chairman Baker. I would like to call this meeting of the Capital Markets Subcommittee to order.

This hearing represents the third such meeting of the committee in our exploration of the need for reform with regard to the marketing and sale of insurance products nationally. The one thing that is clear to date is that the current system is not working as well as it could. And despite the best efforts of state regulators and those involved in the markets, the inability to control the actions of 50 independent regulators is a very daunting task. The end-loser in the process in the current environment, of course, in my view, is that of the consumer, who often finds limited choices or high-priced choices as a result of the lack of competitive forces.

We have had testimony from some CEOs of insurance companies that they simply do not participate in certain states in the marketing of their product because of the regulatory constraints. That certainly is not acceptable.

Having recognized the significance of the problem, it is also apparent that we will not be able to seek resolution in a short-term window. It is a very complicated matter requiring thorough study and examination, and the members of the committee are entitled to have all available information to make the best appropriate decision. However, Chairman Oxley has expressed on repeated occasions his interest in seeing the committee do its work, that we move toward a reasonable goal as quickly as is possible, and that we do it in the most professional manner available to us. As a result, this hearing will not be the last. There is much more work for us to do before beginning discussions of legislative proposals.

In the likelihood that Mr. Kanjorski would be here shortly, he has been the proponent on the committee of what we call roundtables, where we get folks together in a room, roll up our sleeves, and just sit there until we get something done. We are contemplating a roundtable with regard to the issues raised in these three hearings over the course of the next couple of months—and I was praising you in your absence, Mr. Kanjorski, talking about your advocacy of roundtable approaches and that it is advisable, I think, given the nature and complexity of this subject, certainly over the course of the next couple of months to attempt to form an environment for such a roundtable to take place, assisting us in identifying all the areas where it is evident that there is significant agreement.

And I guess that would be sort of the concluding perspective is that as difficult as it will be to have a plan on which all parties can agree, there are significant areas where many people do find agreement and we should move in those areas certainly as quickly as we are able. To that end, I am certainly appreciative of all those who will appear here today. Your input and testimony will be helpful to the committee members as we move forward in the coming months.

With that, Mr. Kanjorski, if you have an opening statement, I would like to recognize you.

Mr. KANJORSKI. Thank you, Mr. Chairman. Mr. Chairman, we meet today for the third time to analyze various proposals to increase the efficiency and uniformity of insurance regulation in the United States. I again commend you for your diligence in convening this series of hearings. Today's proceeding should help us to better appreciate the regulatory models used in other sectors of the financial services industry and how these sectors might be affected under various proposals to reform insurance regulation.

At our previous hearings, we have heard from both sides of the ongoing policy debate about reforming insurance regulation and creating an optional federal charter. Some of our witnesses have argued that the needed reforms are most appropriately pursued at the state level. Others have suggested that joint state and federal oversight would most effectively address the regulatory efficiency problems plaguing the industry. We will hear similar views today.

No matter what side one takes in this long-standing debate, it has become clear to me that there is no longer a question of whether we should reform insurance regulation in the United States. Instead it has become a question of how we should reform insurance regulation.

This reform effort will likely prove difficult given the diversity and complexity of the insurance industry. As a result, I suspect it will take us several years to forge a consensus on this complicated set of issues.

Later today I plan to continue to explore whether we should create a tiered regulatory structure for insurance similar to the oversight system we devised for investment advisors. Under this system, the Federal Government would regulate insurers above a certain size or in a certain business line while states would retain the responsibility for regulating the rest.

We should also continue to carefully examine the consumer issues as we proceed in the weeks ahead. We should, for example, find out the cost and benefits of a streamlined regulatory system.

We should further determine what safeguards are needed to protect the interests of consumers. In the end, consumers should be the ultimate beneficiaries of our action.

Additionally, Mr. Chairman, I am particularly pleased that Wayne McOwen will testify before us today. Mr. McOwen serves as a senior vice president of Guard Financial Group, which is based in my congressional district. Guard Financial Group operates several subsidiaries and affiliates that participate in various aspects of the insurance and financial services industries. I have previously found Mr. McOwen's insights informative and instructive, and his comments today will help us all to better understand the needs of a small, progressive insurer.

In closing, I look forward to hearing from our distinguished witnesses and to learning more about their views for improving insurance industry regulation. As we continue to examine these issues, I am confident that our careful analysis will allow us to eventually identify a bipartisan consensus on the most effective and appropriate way to move forward.

Chairman BAKER. Thank you, Mr. Kanjorski.

[The prepared statement of Hon. Paul E. Kanjorski can be found on page 326 in the appendix.]

Chairman Oxley, did you have an opening statement?

Mr. OXLEY. I do, indeed. Thank you, Mr. Chairman. Today, the committee holds its third and final hearing on its series examining various proposals to reform insurance regulation. I am very pleased that Chairman Baker has devoted so much time and energy to this issue, which is of the utmost importance to insurance consumers across the country.

While we have just scratched the surface of this very complicated matter, this series of hearings has established the foundation for the committee's future work in this area. And I can assure you there will be future work. This committee will remain focused on this issue until true reform is achieved.

As many of you know, my interest in reform is not new. Several years ago, I asked the National Association of Insurance Commissioners to focus on this glaring problem, and they responded in March of 2000 with a statement of intent, "The Future of Insurance Regulation," which established NAIC's platform for modernizing insurance regulation. It was a good first step and laid out goals and timetables for action.

Since that time, the NAIC has experienced some successes and some failures. In the face of congressional legislative pressure, the NAIC has made significant progress in agent licensing reform, and I commend their efforts. However, there is still much work to be done. First, to make reciprocity a reality in every state and to achieve the ultimate goal of uniformity. I also remain troubled that many of the larger states, with the bulk of the agent-broker population, have either not yet passed legislation or have passed legislation that may not meet the NARAB requirements.

Unfortunately, the NAIC has met with less success in its efforts to modernize the product approval process. Almost a year ago to the day, the NAIC testified before this subcommittee and held out CARFRA as the solution to the life insurance product approval problem. Now, the NAIC has largely abandoned the initial

CARFRA approach and has shifted gears to an interstate compact mechanism. The interstate compact mechanism has been around for quite some time and raises some difficult issues. It is too early to say whether such a system will succeed or fail, but one thing is for certain: consumers cannot afford another misstep.

I am here not to blame the NAIC for lack of reform. The leadership team at the NAIC has done yeoman's work, and I would like to thank Commissioner Terri Vaughan, who is with us today, Ohio Commissioner Lee Covington, Illinois Commissioner Nat Shapo, and others for their important leadership efforts.

To a large degree, their hands are tied. The NAIC can approve initiative after initiative but it is the state legislatures that must act on them. Unfortunately, it is becoming increasingly apparent that the NAIC may be facing an insurmountable task.

Mr. Chairman, it is my hope that organizations such as NCOIL, which I helped to found back in the 1970's when I was in the Ohio legislature, will take an active role also in this important reform process.

It is my sincere hope that the alliance between the NAIC and state legislators will bring reform to this industry. However, this committee will not sit idly by. I am committed to continuing working on this issue for the long haul, looking at all the different facets of the industry. We will keep building on our reform efforts, and we will not let up until consumers receive the most effective and competitive marketplace that can be created.

Mr. Chairman, again, my congratulations on this effort at three very important hearings to set the stage for future activity. And I yield back the balance of my time.

[The prepared statement of Hon. Michael G. Oxley can be found on page 324 in the appendix.]

Chairman BAKER. Thank you, Mr. Chairman. Mr. Ross, did you have a statement?

Mr. ROSS. Thank you, Mr. Chairman. Actually, I do not have a statement. I got here early in hopes of being able to ask a couple of questions soon after what I am sure will be some very brief testimony from this panel.

Chairman BAKER. Thank you, Mr. Ross. Mr. Ney? Mr. Gillmor?

Mr. GILLMOR. I will just enter my statement in the record, Mr. Chairman. And I do commend you for moving forward on this important subject.

Chairman BAKER. Thank you, Mr. Gillmor. Mr. Bentsen did not have an opening statement.

If there are no further members wishing to make an opening statement, at this time I would like to move to our panel of witnesses, and I certainly do appreciate all of your willingness to appear and participate. As you probably know, we encourage you to keep your remarks to five minutes. Your prepared text will be made part—if possible, your prepared text will be made part of the official record. And that facilitates us being able to get to our question and answer period, which is usually very productive for us.

With that, I would like to welcome the Honorable Terri Vaughan, who is here today in her capacity as president of the National Association of Insurance Commissioners. Welcome, Commissioner.

STATEMENT OF TERRI VAUGHAN, PRESIDENT, NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

Ms. VAUGHAN. Thank you, Mr. Chairman and members of the subcommittee. It is an honor and a real pleasure to be here with you.

Today, I would like to make a few basic points. First, the sole reason for government regulation of insurers and agents is to protect American consumers. Effective consumer protection that focuses on local needs is the hallmark of state insurance regulation. We understand local and regional markets and the needs of consumers in these markets and we recognize that consumer protection is the purpose of our jobs and the basis of our statutory authority.

The subcommittee's theme for these hearings is insurance regulation and competition for the 21st century. While commercial competition is certainly a significant aspect of the insurance markets in the United States, it has not been the primary purpose of government regulation. The primary purpose is consumer protection. And once the consumer protection responsibilities of government insurance regulators are satisfied, it is fair to ask how the system of regulation can be made most compatible with the demands of commercial competition without sacrificing the needs of consumers. The NAIC and state regulators have given this much attention over the years, and we continue to give this matter our highest attention.

Paying for insurance products is one of the largest consumer expenditures of any kind for most Americans. Figures compiled by the NAIC show that an average family, people right here in this hearing room, can easily spend a combined total of $4,500 each year for home, auto, life, and health insurance coverage. Protecting insurance consumers in a world of hybrid institutions and products must start with the basic understanding that insurance is a different business than banking and securities. Insurance is a commercial product based upon a number of subjective business decisions.

During 2000, we handled approximately 4.5 million consumer inquiries and complaints regarding the content of policies, treatment of consumers by their insurance companies and agents, and many of those calls led to a successful resolution of the problem at little or no cost to the consumer.

During your June 4th hearing one of the industry witnesses testified that a recent Roper opinion poll concluded that the public rates state government is better than the Federal Government at consumer protection and this statement does not surprise us. State regulators know from years of firsthand experience that when consumers need help with insurance sales or claims problems, they naturally look to their local state agency charged with supervising insurers to get assistance.

While recognizing the inherent strength of our system when it comes to protecting consumers, we also agree that there is a need to improve the efficiency of the system. And in March 2000, we adopted the NAIC statement of intent on the future of insurance regulation, endorsing a new action plan to do this. Working in their individual states and collectively through the NAIC, the commissioners have made tremendous progress. And looking ahead we will continue to deliver on the goals and objectives set forth in the statement of intent, that is creating an efficient market-oriented system, regulatory system for the business of insurance.

In Attachment A of my written testimony, you will find a status report on our modernization efforts.

In responding to the demands of insurance consumers in each state, the NAIC generally agrees with the comment by a previous industry witness that state uniformity is not the Holy Grail. However, where appropriate, we are working to achieve full regulatory uniformity to benefit both consumers and insurance providers. And marketing life insurance is one area where we agree with the industry that national uniformity is needed to enable to life insurers to market products nationally.

To accomplish uniform supervision of life insurance products within the state system, we are currently working with state legislators and regulators to draft an interstate compact that gets the job done while preserving necessary and effective state consumer protections. The goal of the compact is to establish a single point of filing, where life insurers would file their products for approval and thereafter, assuming the product satisfies appropriate product standards created jointly by the compacting states, insurers would be able to sell those products in multiple states without the need for making separate filings in each state.

Over the next few months, we will continue to work with legislators and regulators, as well as consumer and life insurance industry representatives to develop model compact legislation.

If I could just for a moment digress and respond to a comment that Chairman Oxley made in his opening comments. We have not abandoned CARFRA. In fact, we view CARFRA as a critical first step to creating an interstate compact. Through CARFRA we developed uniform standards, we developed a coordinated review process, and we continue to pursue CARFRA because it provides essential building blocks for the interstate compact. In fact, in June we just added 12 new states to CARFRA, I think demonstrating that CARFRA remains an important element of our reforms.

The subcommittee asked us to address a few specific questions in our testimony, and let me do that. In the producer licensing reform area, to date 46 states enacted legislation designed to satisfy Gramm-Leach-Bliley and that legislation is being considered by four additional jurisdictions. This represents about 76 percent of total nationwide premiums. While these numbers are significant, we continue to work toward the goal of uniformity.

In approving the insurance product approval process in both life and property and casualty industries, I previously mentioned our work on the interstate compact for life and annuity products. In addition, we are working to achieve operational efficiencies in the rate and form filing area. And we are pursuing changes to the regulatory framework for property and casualty rates and forms.

Our achievements and goals for operational efficiency are detailed in my written statement. However, I would like to highlight one area. That is our electronic rate and form filing system, SERFF. Almost 500 companies are now using SERFF, are filing rates and forms with the states. One company told us that with

SERFF, its cost per filing has dropped from $38 down to less than $10 per filing with added savings because regulatory review is done more quickly. With SERFF, we have a ready-made opportunity to streamline and generate savings to companies and presumably their customers, and we wonder why more companies are not taking advantage of SERFF since many have testified to the NAIC about the cost and the time savings.

In the area of market-based regulatory reform, the NAIC has developed a streamline model law to implement reforms for commercial lines. Recent consideration of commercial lines rate regulation led to the conclusion that commercial insurance consumers will generally be better served by less restrictive regulatory interventions and a greater reliance on competition. We are working with state legislators to enact the model in the states, and we are also studying the benefits of market-based models for personal lines markets. However, we have not yet concluded our recommendations.

The system of state regulation in the United States has worked well for 125 years. We understand that protecting America's insurance consumers is our first responsibility. We understand that the markets have changed and that modernization of state insurance standards and procedures is needed to ease regulatory compliance for insurers and agents.

We ask Congress and the insurance industry participants to work with us to implement the NAIC's modernization initiatives through the state legislative system. It is the only practical way to achieve the necessary changes quickly, in a manner that preserves the state consumer protections that are expected by the public. The state process may take more effort than having an insurance czar in Washington but it rewards the citizens and consumers in each state by giving them control over important aspects of insurance and claims procedures that affect their financial security and the communities in which they live.

We look forward to continuing to work with Congress, with you, and within state government to improve the national efficiency of state insurance regulation while preserving its long-standing dedication to protecting American consumers.

Thank you.

[The prepared statement of Terri Vaughan can be found on page 411 in the appendix.]

Chairman BAKER. Thank you very much. It is evident we have votes on the floor. I was thinking this through. If anybody understands the assumption of risks, probably our four witnesses do. You have just assumed a three-vote risk. Rather than rush the next witness and try to get the testimony in before we have to leave to vote, I suggest we recess now. We will return as quickly as we can. I am going to guess about 20 minutes. And as soon as I can get back, we will start back up again.

We stand in recess. Thank you.

[Recess.]

Chairman BAKER. We will now reconvene our hearing. Members will be filtering back from the vote momentarily. But given that, and not wanting to detain anyone longer, let me introduce our next witness, Mr. Tom Ahart. Is that correct? President of the Independent Insurance Agents and Brokers of America.

Welcome, sir.

STATEMENT OF TOM AHART, PRESIDENT, INDEPENDENT INSURANCE AGENTS AND BROKERS OF AMERICA

Mr. AHART. Thank you very much.

Chairman BAKER. You will need to punch your little button on that thing. Got it? There you are.

Mr. AHART. Thank you very much, Chairman Baker. I appreciate the opportunity to be here and appreciate the full committee and the subcommittee looking into this issue.

We have listened to a lot of testimony and read testimony from the other hearings and would like to say that we agree that there is definitely a need for reform in the regulatory area. When we look at the way it is regulated right now that the state basis, there are a lot of good issues at the state basis but there are two issues in particular which we need to help and that is the speed to market issue and the over regulation in the licensing and post licensing audit issue.

On the speed to market issue, as an agent, especially from New Jersey, I can tell you there is definitely a problem in getting products—new products out to consumers. Often it is years before new products can get to consumers, which hurts insurance companies. It hurts the agents and brokers. And it hurts the consumers, who don't have the opportunity for the new types of programs. So we definitely need to do something with that.

There is also still a problem with licensing, both at the company and the agent-broker end, and we would like to do something with that.

So although we recognize the need for reform, we don't agree with some of the other proposals in certain areas. First of all, from the proposals we have heard, there are really two. One is to keep the status quo, which would keep the state regulation basis as it is. And although we think the state regulators do a fantastic job for the most part in protecting consumers, there are certain areas, as we mentioned, with speed to market and licensing issues that remain a problem. Again, I would like to say that the state regulators in protecting the consumers are great in making sure that minimum coverages are provided. They are great in taking care of claims disputes and claims inquiries which happen often at the state level. And they are very good at operating their guarantee fund, which has not had to any taxpayer input since its inception in the 70's.

The other option, other than status quo, is going with federal charters and some type of federal regulation. Our problem with the federal regulation overall is, number one, we believe it is overkill. We think that there definitely are problems in the system, as we mentioned, with speed to market and with inefficiencies in licensing. But, as we also mentioned, there are a lot of good things that are done by the state regulators. And the federal charters or federal regulation doesn't necessarily tackle the problem. I can see situations where you could have a new federal bureaucracy or federal legislator which actually operates as one of the poorest states might operate or one of the ones that don't do the job so well and you could actually then be hurting other states that have good regulation.

Again, coming from New Jersey, we have great state regulators but we have some real political problems that impede what they can do. And in those situations, if we had something like that at the federal level, which there is no guarantee it wouldn't be that way, it would be terrible for everybody.

So, first of all, I think that it could be overkill. Second, I don't necessarily see that it attacks the problem. The problems are, again, speed to market issues. The problems are inefficiencies in licensing and whatnot. And federal charters don't necessarily attack those issues.

What I would like to propose is our solution, which we have been working together with different insurance companies, with different agent-brokers groups, with state regulators, and with legislators. And we are offering a pragmatic middle ground approach, which is a compromise between the status quo and federal regulation. What we believe is that we should continue to use state regulation, which has worked well for over 150 years but use federal legislative tools to help with specific issues.

To give you some examples on the speed to market issue, we would use uniformity and a model similar to the Illinois model in that on forms we would use file and use provisions with a 30-day review period so that when products are—when forms are filed, the regulators would have 30 days to look at them and they would be deemed approved unless they are disapproved, which would move products along.

On the rate end, we also would follow the Illinois model where we have the competitive market model. And the rates would be filed but they could not be disapproved on competitive markets. States would only be able to disapprove them on non-competitive markets.

Well, on agency and company licensing we would really use reciprocity, which is starting to work now with the NAIC model. And what we would do is have both companies and agents have approval in their resident states. And once they are approved in their resident states, they would be able to have reciprocal, non-resident licenses in other states by just showing their current resident license as well as paying the fee.

In addition, in market conduct exams, we think that that should be regulated better and that it is completely inefficient right now and we try to move those inefficiencies and reduce the cost. We would try to limit the use of those in non-resident states so that they can only require an exam to review compliance with properly promulgated statutory and regulatory requirements.

Also, just getting back to the agency company licensing end for a minute, we think that you could use the legislative tool of preempting states rights, for instance, on the counter signature laws, which would get rid of those if they are a problem.

So, in conclusion, I would just like to say we recognize that there is a problem. We ask Congress to help as soon as they can. We believe that they should meet with the states and work with the NAIC and come up with a solution similar to our proposal, which is a middle of the ground, pragmatic approach which uses the well-founded base of state regulation but uses legislative tools to help. And we believe that would protect consumers in the outcome.

Thank you very much.

[The prepared statement of Tom Ahart can be found on page 330 in the appendix.]

Chairman BAKER. Thank you, Mr. Ahart. We appreciate your testimony.

Our next witness is Mr. Glenn J. Milesko, president and CEO of Banc One Insurance Services Corporation, appearing here today on behalf of the American Bankers Insurance Association and the Financial Services Coordinating Council. Welcome, Mr. Milesko.

STATEMENT OF GLENN J. MILESKO, PRESIDENT AND CEO, BANC ONE INSURANCE SERVICES CORPORATION, ON BEHALF OF THE AMERICAN BANKERS INSURANCE ASSOCIATION AND THE FINANCIAL SERVICES COORDINATING COUNCIL

Mr. MILESKO. Thank you, Mr. Chairman. The banking industry—

Chairman BAKER. And you will need to pull that mike a little closer. It is hard to hear you, sorry.

Mr. MILESKO. The banking industry is keenly interested in the regulation of insurance because it is actively engaged in that business. In 2001, 1,900 banking organizations were in the insurance business. And ABIA's member banks sold more than $50 billion in premium volume.

Our experience with the state regulatory labyrinth has led us to conclude that it is not suitable for all insurers and producers, especially those operating in multiple states or using the Internet to reach consumers. An alternative is urgently needed.

These hearings show that many others share our frustrations with the lack of uniformity among state laws, the failure of the existing system to allow products into the market on a timely basis, the continued existence of multiple agent licensing and continuing education requirements, and the competitive disadvantage insurers face relative to banks, security firms, and mutual funds in the delivery of like financial products. And these shortcomings remain despite federal pressure on the state system to modernize.

We believe that the solution to this problem is to give insurers and producers a choice between federal and state regulation. Federal regulation would be an option, not a replacement, for state regulation. The system has worked well in banking for 140 years. We believe it would work well for insurance.

Dual chartering has actually strengthened the banking system—the state banking system. Over 70 percent of banks are state chartered and it is the charter of choice for new banks. Why? Choices has kept banking vibrant, innovative, and diverse. The alternative regulatory environments serve as laboratories for change that have led to the development of products that are now commonplace, all to the benefit of consumers. Choice has also promoted better, more efficient supervision. Any soulution must also rely on market-based competition rather than price controls for establishing rates for insurance products. It is ironic that we avoid price controls on food, clothing, and shelter, commodities more necessary to human survival than insurance, yet rate regulation persists all to the detriment of consumers.

Last year, Illinois state representative Terry Park, then president of NCOIL, testified before this committee that because his state eliminated rate regulation for auto insurance, such insurance is readily available to consumers, and at a lower cost than in other states. He also noted that Illinois has more than double the number of competing insurers than either Massachusetts or New Jersey, two states whose rigid rate controls have led to the highest average auto rates in the nation.

For these reasons, our optional federal charter proposal does not permit regulation of rates or forms. Instead, we would protect consumers through strong solvency and market conduct standards and the application of antitrust laws. Our proposal includes risk-based capital standards, investment standards, and dividend restrictions. Federally chartered insurers and producers would also have to adhere to vigorous market conduct standards, preventing unfair competition and deceptive acts and practices.

Regular reporting, examination of federal insurers and producers, and strong enforcement authority would be part of the federal regime. The combination of strong solvency and market conduct standards, backed by examinations and potential enforcement actions, would ensure that federal insurers and producers operate for the benefit of policy-holders and that consumers are protected.

Now, let me broaden the perspective and speak for the insurance banking and securities interests that together make up the FSCC. In my 30 years in the insurance business, I have never encountered an issue this significant where there is such agreement. Here, these industries are approaching Congress shoulder to shoulder with a single message. We agree on the nature of the problems confronting the current system. We agree on principles for addressing those problems. And we agree on the details of a legislative solution.

This consensus reaches beyond the FSCC. The Financial Services Roundtable, the Council of Insurance Agents and Brokers, the Financial Services Forum, all are in support of an optional federal charter.

In large measure, we credit this consensus to your efforts, Mr. Chairman, and to the efforts of Chairman Oxley for moving in a deliberate fashion to investigate the workings of the state regulatory system. We are grateful for your interest and believe these investigations have favored support for a comprehensive rather than an incremental approach to regulatory reform. The scope of the problem is simply to great and the need to act too strong for incremental measures to succeed.

Mr. Chairman, there is a rare convergence of interest here and a broad consensus for a very specific course of action. On behalf of the ABIA and the FSCC, I urge you to move forward with an optional federal charter for the insurance industry. The members and staff of the ABIA and the FSCC stand ready to assist in this endeavor.

Thank you very much.

[The prepared statement of Glenn J. Milesko can be found on page 358 in the appendix.]

Chairman BAKER. Thank you very much, sir.

Our next witness is Mr. John Van Osdall, Chairman, Council of Insurance Agents and Brokers. Did I pronounce that correctly, sir?

Mr. VAN OSDALL. You did.

Chairman BAKER. Oh, terrific.

STATEMENT OF JOHN VAN OSDALL, CHAIRMAN, COUNCIL OF INSURANCE AGENTS AND BROKERS

Mr. VAN OSDALL. Thank you, Chairman Baker.

Chairman BAKER. You are welcome.

Mr. VAN OSDALL. And Ranking Member Kanjorski and subcommittee members, thank you for the invitation to be here today.

Today, I am representing the Council and I think, as you know, the Council of Insurance Agents and Brokers tends to represent the insurance agents in the United States that represent the larger business interests. We probably handle or place each year about 80 percent of the commercial insurance business that generates throughout the United States. So that is really our phase and the direction that we would like to have our comments made in today.

We want to thank the fellow panelists also, particularly Commissioner Vaughan, who has done yeoman's work in the area of licensing for us and licensing reform, and that is very much appreciated. It has gone a long way and we know that we still have a ways to go. So thank you very much.

And Tom Ahart is with us today in a capacity that also is very similar to ours in the idea of believing that this is the time for more federal intervention in the regulatory process.

We really feel strongly that this is the appropriate time to begin talking about the options for federal regulation and federal intervention. And to that end, our FAME organization, which is really a newly created research report that was being released today for the first time, is entitled, "The Cost and Benefit of Future Regulation Options for the U.S. Insurance Industry." About a year ago, we engaged an independent economic consulting firm to do a study of regulatory approaches and options that we should be considering. And we think they have done a good job and are looking forward to sharing this with you.

The Council is also very interested in the possibility of SROs. We have watched the SROs work in many models in professional organizations throughout the United States. We think that this may offer a real opportunity and hope that the committee will look into the SRO model. We have seen it work in the bar associations for years throughout the United States. And we feel that this may be the kind of solution that could be meaningful as you consider it.

Apparently the states have crossed the threshold in adopting NARAB. And I think it should be commented also that the NARAB model itself is based on the National Association of Securities Dealers' models. So this is another SRO that we think has done well over the years. We really suggest that you seriously consider it as you go about your deliberations.

We really support reform in any form. We need reform. The idea of the speed to market that you are now considering, the idea of the flexible rates and policy forums that you are now considering, we think is really a step in the right direction and we applaud you for that.

None of the concepts and the regulatory approaches that you seem to be considering we think are mutually exclusive. We think that there is room for each of these considerations and would like to do anything we can to encourage that.

Again, NARAB we think is a good template. It is really a carrot and a stick sort of a template. We think that it has a good effect. We think it has had the result of improving state regulation. We think that without the NARAB as the carrot and as the stick, that we would not have nearly made the progress that we have made. We think the Illinois model is really the great model for the future of insurance regulation and that would be beneficial for our clients, who again tend to be the larger commercial insurance buyers.

We also know that congressional oversight is very important and whether it be done by an independent, newly created agency or a part of an existing agency, like the Treasury Department, would be workable from our vantage point. We think that that will also be encouraged by the optional federal chartering.

So we are here to support to you. We thank you for what you are doing and want to be a part of anything we can do to further the effort.

Thank you, Mr. Chairman.

[The prepared statement of John Van Osdall can be found on page 401 in the appendix.]

Chairman BAKER. Thank you very much. Mr. Shows, did you have a statement? Yes, I will get you in regular order. Thank you.

Commissioner Vaughan, I was interested in how the compact process would actually be formalized. As I understand it, the compact has not yet been formally prepared so there is not a document yet ready to circulate. That is subject to NAIC approval, I believe. Which would then have you take the next step of going to each state legislature to adopt the provisions of whatever the compact elements are. And my question is, in good faith, what do you see as the time necessary to achieve that in light of what has happened with NARAB?

Ms. VAUGHAN. Well, in light of the producer licensing activities, the enactment of Gramm-Leach-Bliley slightly less than three years ago, we now have legislation enacted in 46 states. Now, I am not going to say that we could enact interstate compact legislation in 46 states in two-and-a-half years. I think that would be a pretty optimistic time frame. But I do think the key to all of this, as you have said, as Chairman Oxley said, is the participation and support of the state legislators. We are working very closely with them on this. They have the—NCSL has a task force to streamline and modernize state insurance regulation, and they spent about a day in Philadelphia a week ago working on the interstate compact draft with us, having a hearing, inviting people to come in and testify, and making some suggestions to us on ways that we could improve the draft so that it could be acceptable to the legislators.

So we are working very closely with them. And our plan is to have it in a form that we can adopt as a membership of the NAIC in September and hopefully have some legislative endorsement at some point in the fall so that we can introduce it in state legislatures next January. I think if we can do that, and I am confident we can meet that time line, I believe that we can very quickly get a significant group of states in place to make the interstate compact operational.

The current draft that we have says that the interstate compact does not become fully operational, in the sense of approving products, until we have at least 26 states or 50 percent of the market. And I am pretty confident that we could do that in short order.

Chairman BAKER. So you are basically guesstimating a three to five year window?

Ms. VAUGHAN. You are going to make me put a time frame on this.

Chairman BAKER. Oh, I was just going to give it my best shot.

Ms. VAUGHAN. Boy, let me tell you with respect to producer licensing. The challenge that we have had is that we can get a whole bunch of states very quickly, we did that in producer licensing. We got 46 states. And then we have got four or five jurisdictions that you just have to pull along and pull along and really work with. And the challenge that we face is that we are as an organization unfortunately are being judged by you folks in terms of all states. And when it is really—it is just a few states, it is three or four states that are a problem and it may be a problem in the interstate compact. We are working very hard to get the large states on board, and we believe that we are going to be able to do that. But I would have a hard time promising and committing to all 50 states in a particular period of time.

Chairman BAKER. I understand. Thank you.

Mr. Ahart, how do you feel about the Illinois model? Do you find that to be a reasonable structure?

Mr. AHART. Yes, definitely. As we look to the speed to market issues, first of all, with forums it would be a perfect model for us. And then it would be a file and use model in that companies would file their forms and they would have 30 days to approve them. And they would know within 30 days whether approved or not and then they could use them. On the rate side, it is pretty much a free marketplace on the rates. They file the rates but they are allowed to use them right away on a competitive marketplace. If a certain marketplace is deemed uncompetitive because of very few companies writing the business, then the state would have the ability to work on those rates or approve or disapprove them. But it would be a great model. And that was one of the legislative tools we would like to use by adopting similar provisions to the Illinois model.

Chairman BAKER. What would be your objection to the Illinois model being made national?

Mr. AHART. I would have no objections to that.

Chairman BAKER. Terrific.

Mr. Milesko, do you think the Illinois model goes far enough for you?

Mr. MILESKO. It is a good model. We like the free competition, but we also are concerned that—I think we are concerned that it doesn't go far enough in terms of allowing some of the other issues to be addressed. It does talk about the licensing. It talks about the rate and forms. But I think there are other issues that still need to be addressed that are much broader than just what we are doing in Illinois.

Chairman BAKER. And if you would for at least my purposes, I would love to have your written thoughts as to the objections of pursuing a line of that sort. In trying to understand it, it would be helpful to know the specific areas of contention that the organization would have with that type approach.

Mr. MILESKO. Well, right now we operate in all 50 states. When we look at the issues that we have in terms as an insurance company, it just addresses I believe the agents. For example, in one state it takes us over a year to get our certificate of authority. In other states, such as North Carolina, Connecticut, there is a three year seasoning requirement for the legal entity to be licensed in doing business before it can get approval in those states. In many cases, the capital surplus requirements are much higher than the NAIC model. So I am looking at it from an insurance company perspective as well as from a national agency perspective where we need to be licensed with our 5,000 agents in all the states.

Chairman BAKER. Sure, thank you very much. My time has expired.

Mr. Kanjorski?

Mr. KANJORSKI. I am going to put you on the spot, Ms. Vaughan. Could you name the three to four states that give you the worst trouble?

Mr. MILESKO. From my standpoint, the states are New York, California, Texas are some of the worst states.

Mr. KANJORSKI. Are the worst states?

Mr. VAN OSDALL. May I comment on that?

Mr. KANJORSKI. Yes.

Mr. VAN OSDALL. From a licensing standpoint, the big three that we are missing, really, are California, New York, and Florida. They have a significant portion of the premium. In fact, the Council of Insurance Agents and Brokers filed suit against both Nevada and Florida this past week because we continue to have such concern about the punitive income- sharing arrangements that those two states protect their local agents with. That has been of great concern to us. That has a real impact on our business.

Mr. KANJORSKI. So it is just the small states that give you trouble?

Mr. VAN OSDALL. Just the small states, right.

Mr. KANJORSKI. What is the worst disadvantage if we went to a federal or a federal optional charter, Ms. Vaughan?

Ms. VAUGHAN. I think the worst disadvantage would be the inability of the regulators in Iowa to address the local market issues in Iowa. And to give you a specific example, we have a very large senior citizen population in Iowa. We have the highest percentage I think in the country over 85. And so that means that we have had to focus a lot of attention in that area. And I guess I have concerns as a regulator from Iowa about whether the federal regulator would be sensitive to the market issues that we encounter in Iowa.

Mr. KANJORSKI. Very good. Mr. Ahart, you are sort of looking for the best of all worlds, state regulation, federal legislative tools, and reciprocity of licensing. That would be Christmas on the Fourth of July, right?

Mr. AHART. I think it is very doable actually. Right now, we have a very good state regulation process in almost all areas. The one problem again with federal charters, whether they are optional or mandatory, is for agents and others they are mandatory because you would have to deal with your national companies as well as your regional companies. And they are against speed to market, licensing issues, things like that. If you went after each issue with federal tools for uniformity and reciprocity and let the state regulators handle the rest of it, which they are doing so well, you could tackle those issues as they came about. So I think it is very doable.

Mr. KANJORSKI. Mr. Milesko, you talk about the federal optional charter, and what I am curious about, if we were to allow insurance companies to select a federal charter or state charters, how would that impact on the cost of administration at the state level? Wouldn't that take money that now flows to the states for regulation and take that away from them and have to flow to the Federal Government for regulation and wouldn't there be a shortfall since we are having two distinct bodies of regulation, how do you make that distinction up?

Mr. MILESKO. I think the insurance companies that are national companies and national agencies that would opt for the federal charter would pay the costs. And those companies also would still participate in the guarantee funds.

Mr. KANJORSKI. But would they contribute to the states?

Mr. MILESKO. Yes.

Mr. KANJORSKI. In other words, pay the states, as you are now, and pay an additional fee for the benefit of the federal charter?

Mr. MILESKO. Yes.

Mr. KANJORSKI. Okay.

Mr. MILESKO. It would overlay on top of the state system.

Mr. KANJORSKI. And you think there is uniformity in the large companies to assume a greater burden of cost for regulation?

Mr. MILESKO. I think the cost savings would more than pay for—

Mr. KANJORSKI. Offset.

Mr. MILESKO.—the additional costs that they would pay for a federal regulator.

Mr. KANJORSKI. Okay. Mr. Osdall, while you were talking about the tremendous accomplishments of the SROs, the chairman and I had a slight discussion on the auditing field. Do you think that they do the best in the world?

Mr. VAN OSDALL. I do not have any comment on that.

[Laughter.]

Mr. VAN OSDALL. I think if you look at the—I can't speak to the auditing field, excuse me. No.

Mr. KANJORSKI. You are turning into a good politician. That is what we do, shut up when you can't say something good, right?

I think this has been a great panel, Mr. Chairman, in terms of setting out all the choices. I am just wondering—going back to your opening statement and my tremendous affection for roundtable discussions, I hope the panel that is here today are part of that roundtable because I think they would certainly help us to find some common ground. And their input I think would be most worthwhile for the committee.

Chairman BAKER. I thank you, Mr. Kanjorski. It will be a big roundtable and we will try to get everybody a seat.

Mr. Ney?

Mr. NEY. Thank you, Mr. Chairman. The question I had, Mr. Van Osdall, under some of the proposals, you would have to have a federal charter license and then you would still have to have a state license, I assume. Would you support that dual regulatory licensing situation?

Mr. VAN OSDALL. Well, we know that at the end of the day there is going to be some dual regulation. I think we don't escape that. I think one of the interesting things that you will see in our report that is being released today is of the premium taxes that are taken by the various states, about 10 percent of that amount is actually used to run the regulatory agencies within the state. So we know that we are already paying a tax to the state. We therefore also feel that the additional cost—going to Mr. Milesko's comment about also satisfying a federal regulator where necessary—at the end of the day we think will cost less in the hidden or internal costs of an insurance company in providing the consumer the product. That does not seem—the duplicative cost does not seem to be a concern when we weigh it against the benefit of the ease of doing business and being able to more quickly deliver the product to our client.

Mr. NEY. One other question based on state and fed. Several years ago, the FTC started to look at business practices and Congress banned them from doing that because you are state regulated. If we embark down this path of the federal charter, would you accept the fact the FTC and such other entities could look at your business practices and do an entire regulatory scheme?

Mr. VAN OSDALL. We would do that.

Mr. NEY. You would accept that. One question I had for anybody who would like to answer, if you could. What are you hearing from the consumers of the country? Are they focused at all, any people calling and consumers saying, "Gee, I think fed is better than state." Is anybody actually hearing from any of the consumers that use your product?

Mr. MILESKO. Maybe I could take a try at that.

Mr. NEY. I am not talking about the ones you might have wrote a letter to to tell them about the hearing. I mean genuine people.

Mr. MILESKO. One of the things that we have been able to do on the bank insurance side is use a lot of the banking systems because of the penalties, when you violate any of the banking regulations and apply those to the system that we have put in place on the insurance side.

To give you an example of that, last year we did $2.7 billion in annuity sales and because of the systems and the edits that we have built in, there were less than $5,000 of complaints and charge-offs that we had to make good for consumers. So the number of complaints we get in relationship to the premium volume that we write is de minimis. And I think part of that is because we try to the extent we can to systematize everything we do. And if we went with the optional federal charter, it would make it that much more efficient. And I could give you some examples of very specifically today, in terms of pre-licensing education, just to deal with licensing but you take each one of these issues separately. In Arizona, there is no requirements. In Colorado, there are 90 hours of pre-licensing study.

Mr. NEY. Let me interrupt you—on my time, but what about the consumers? What are you hearing from—I understand you are saying—I gather you are saying there will be better educational practices.

Mr. MILESKO. Right.

Mr. NEY. You will be better able to do better for the consumers. Are you actually—anybody hearing anything from people that are calling up and saying, "Hey, I have been looking at this issue."

Mr. AHART. I would just like to say that we have—being an insurance agent, we deal with our consumers all the time. We talk to them actually a lot about state versus federal regulation. Their biggest concern is there is a lot of questions on claims and coverage situations and things like that that they feel fairly comfortable going to their State Department of Insurance on. And I think they would be very uncomfortable going to a federal bureaucracy to find those problems—they like to deal as local as they can with those issues.

Ms. VAUGHAN. I would say we don't have a lot of consumers calling us out of the blue and saying what they are thinking about having federal regulation of insurance, because the average consumer is not really aware that this debate is going on. But when I am out speaking and I am talking to consumer groups or I am talking to high school teachers and I make them aware of the debate, I can tell you, the reaction I get is not a good one. They want to know that they can go to their local insurance regulator to deal with issues. And that gets back to the 4.5 million consumer inquiries and complaints that we have every year and the fact that they know that there is someone there that can contact when they have a problem.

Mr. NEY. Sorry, Mr. Milesko. Did you have an observation on that or the consumers or any interaction?

Mr. MILESKO. Well, I think the biggest thing for consumers is the access to new products, innovative creative products, and what we have been able to do, for example, with annuities and some of the other products that we are now bringing to customers and consumers that maybe didn't have the opportunity to get that in the past. And I think generally if you look at the track record, there aren't fines, there aren't penalties, there aren't consumer complaints, there aren't censures.

And I know in one of the other panelists' testimony they were talking about the number of consumer issues. And I guess the point that I would make is with the optional federal regulator and the way we would put it together, I think you would cut down on the number of complaints and offer the consumers potentially better products at lower cost because of the savings involved.

Mr. NEY. My time has expired. Thank you.

Chairman BAKER. Thank you, Mr. Ney. Mr. Ross?

Mr. ROSS. Thank you, Mr. Chairman. And, first for Mr. Milesko, I am trying to sort this thing out and figure out exactly where I am going to come down. And one of the concerns that I have, and all of you have done a great job today in providing testimony that has been very helpful to us, both verbally and in writing, and I want to thank each of you for joining us here today, or at least a few of us. For property and casualty insurance, state insurance regulators often play an important role in helping to ensure that claims are paid. I served for 10 years in the state senate, so I have some understanding of how it works at the state level. This involves helping to interpret the insurance contract under the law of the pertinent state to determine whether a valid claim has been asserted. From everything I understand, the consumers, at least in my state, are happy with this system. As far as I can recall, 10 years as a state senator and 17 months as a Member of Congress, I have never had a constituent upset with the aspect of insurance regulation and how it works by each respective state, at least at this time.

Why do you think that my constituents in rural Arkansas would be better protected by a distant federal regulator located in Washington, D.C., some 1,200 miles away, rather than one located in our capital city in Little Rock, some hour and a half away.

Mr. MILESKO. Well, the state laws, number one, would continue to apply. The federal regulator would regulate those national companies and national producers but it would overlay, again, on the states. I mean in terms of the state regulator would still be involved.

In terms of the claim payment on the property and casualty side, I would have to think about that a little bit in terms of the complexity with which those claims come in. From my standpoint, I think to the extent we can simplify the entire process, a sign of an intelligent man I think is to take something very complex and make it simple. And one of the things that we have done in the insurance industry is we have made it very, very complicated, overly complicated from the standpoint particularly on commodity products, such as auto and homeowner's. And I think a lot of that may be smoke and mirrors. A commodity product, if there is a claim such as an auto policy or a homeowner policy, it pretty much goes down to what the forum says and that determines whether there is a claim or isn't a claim.

Mr. ROSS. You said you need to think about it a while, and I think a lot of us need to think about a lot of aspects of all of this before we move forward with trying to pass a piece of landmark legislation that will totally change how we have done things forever.

If you could be so kind, sir, after you have had time to think about, if you could maybe provide me or this committee, especially me, with a letter of your thoughts—

Mr. MILESKO. Absolutely.

Mr. ROSS.—on how it can be regulated from Washington, how is that best going to serve my constituents as opposed to being regulated at the state level. And I know you said you need some time to think about it, and I respect that. But after you have thought about it for a while, and I will let you define what a while is, then if you could provide to me in writing and perhaps this committee, I would appreciate your thoughts on that.

One follow-up question. Do you know how many people currently work for all the—collectively for all the state insurance departments nationwide?

Mr. MILESKO. No, I do not.

Mr. ROSS. It is 11,000, roughly. It is roughly 11,000. And with the proposal that you are advocating being optional, I can only assume that all the current state employees would still be needed on the state level. So what is your projection, I am looking for a number, regarding how many people the federal insurance regulator would need to employ? How many jobs—keeping in mind that this country is already spending $1 billion every 24 hours simply paying interest on the national debt, given the current financial condition of this country, exactly how many new federal jobs do you propose that we create and roughly how much do you think we would need to pay each of those people a year?

Mr. MILESKO. Well, I think it would be considerably less than using 50 states to do the regulation. I think if you look at the total cost of the state insurance regulation, if my figures are correct, it is $880 million. You compare that with say the OCC, a federal regulator does it for $400 million. So I think there could be some savings there over time. The cost of the regulation, again, is paid by the industry at this point, the number of individuals it would probably be similar to one of the other federal regulators, if you looked at it as an example. But I think those are issues that would need to be looked at and worked through.

Mr. ROSS. So are you saying that we could reduce the 11,000 state employees that are out there?

Mr. MILESKO. I think there possibly could be some redundancy depending on how—

Mr. ROSS. And you think you could do it at the federal level for less than 11,000 employees and do it as effectively and as timely?

Mr. MILESKO. I think you could on a national basis. You would eliminate—think about it. You have got 50 states, 50 different ways of doing things. Fifty different systems that currently are in operation. If you have one, it is very logical to assume that you are going to do it much more efficiently.

Mr. ROSS. Where are we going to find these people that already have training and are qualified?

Mr. MILESKO. Well, if you look at when Banc One got into insurance, we now have 5,000 licensed agents. Where did we find them? We found them from the independent agency system. We found them from colleges that we trained and educated to do that. I think there are a number of people that are involved in regulation, involved in insurance and would look at that as an opportunity.

Mr. ROSS. So what was the number again on how many jobs you would propose that we create?

Mr. MILESKO. I don't have a specific number. I think that is something that you would have to work through as we have further dialogue on the proposal.

Mr. ROSS. A hundred? A thousand? Ten thousand?

Mr. MILESKO. I think it is going to be less than a thousand, considerably less because if you looked at 50 states with 11,000 and one federal regulator, I would think there has got to be some—it has got to be a lesser number. I don't know if it would be mathematically proportional but there would be a lesser number.

Mr. ROSS. So this government that is going back to the days of deficit spending for the first time since 1997 is spending a billion dollars every 24 hours paying interest on the national debt, we probably—at a time when we need to be cutting government, you are proposing that we increase to the tune of maybe a thousand new federal jobs?

Chairman BAKER. Mr. Ross, if I may, your time is well exhausted.

Mr. ROSS. Well, if I could—

Chairman BAKER. We will come back to you because there is not going to be many of us here in a few minutes, and I want to give a couple of other members time, particularly your ranking member wanted, without objection, one minute to follow-up on a prior comment.

Mr. KANJORSKI. Yes, Mr. Milesko, in response to Mr. Ross and your response to me seem to be different. I asked you whether or not the insurance industry would maintain in what I understand your optional charter, which would mean all of the states would have to maintain their commissions and process, and there would be additional federal regulator cost, you seem to indicate to my answer that the companies were going to pick up that additional cost.

Mr. MILESKO. That is correct.

Mr. KANJORSKI. Are you saying now that you are looking to get an efficiency out of reducing the states' participation and making that up on the federal level and paying for the federal level or are you making a commitment for your association that the insurance industry is going to pick up the additional cost, whether it is a thousand additional employees or 10,000 additional employees? I thought that is going to come out of the cost of the insurance industry.

Mr. MILESKO. The insurance companies and the national producers that choose to go—or the optional federal charter would pick up the cost.

Chairman BAKER. Let me make sure we get the answers correct, because it is apparently a misunderstanding, I think, as between the answers to Mr. Kanjorski and Mr. Ross. If you would not mind on that particular point, just give us a letter back that explains the companies' willingness to pay appropriate cost because we can't do both. We can't save money by not paying for the state if we are going to tell Mr. Kanjorski we are going to pay for the state and the federal. And therein is the conflict, if we are understanding it properly. Is that satisfactory, Mr. Kanjorski?

Mr. KANJORSKI. Yes.

Chairman BAKER. Ms. Biggert?

Mrs. BIGGERT. Thank you, Mr. Chairman. I guess I should say that I am very proud to be from Illinois, hearing all about Illinois' model. And I have to say that I was in the state legislature, but I can't take credit for the passage of the model, since it happened before I was there. But I think that what has happened in Illinois has been very good, and it really is a model for the country.

Commissioner Vaughan, I wanted to ask you about dealing with the state legislatures again. About how long does it take from the time that a state legislature might decide to pass a model law that NAIC has from the inception to final adoption of a law that you have suggested?

Ms. VAUGHAN. That is going to depend to some extent on the state in Iowa, for example. We know that we need to get this model, speaking of the interstate compact, or any model, producer-licensing model a couple of years ago, we needed to get that adopted by the NAIC and ready to go very early in the fall because many state legislatures come into session in January. And so you need that lead time in the fall to get the bill drafted and into the hopper in the states.

So there are a number of states where you can, if we have something ready in say, September, you can get into the state legislatures in January. There are other states that only meet every other year. And so you have to wait an extra year to get it in.

And then there are some states where the legislative process just tends to be slower and they need to mull it over for a while. We are seeing that happen, for example, in New York, with the producer licensing legislation. It is something that has been in there for a while but they are kind of working it through the system.

Mrs. BIGGERT. More like the time that it takes Congress probably to adopt something.

Ms. VAUGHAN. Right.

Mrs. BIGGERT. Have any of the NAIC model laws been adopted by state legislatures without amendment so that it might be uniform?

Ms. VAUGHAN. Certainly. A number of our accreditation models, the models that the NAIC has required for accreditation, risk-based capital, codification, use of the examiner's handbook, financial examiner's handbook, many of those are adopted on a very widespread basis with very few amendments. There may be in one or two states but it tends to be a highly uniform system in financial regulation.

Mrs. BIGGERT. Okay, well, some efforts have been made to streamline the agent's license through passage of NAIC's model producer licensing law and through construction of a single point filing mechanism, CARFRA. Have any of these licensing laws passed exactly the same in many of the states?

Ms. VAUGHAN. In the producer licensing area, we can get you specific numbers on how many of the 46 states did exactly the uniform producer licensing model, a number of states did. Not all of the 46 states, I have to be honest with you, did it. But I think a critical thing is that of the 46 states they all enacted the elements that were necessary for us to build a streamline non-resident producer licensing system.

One of the things we are trying to do is build a system where an insurance agent can go one place, file one application, do it electronically, have it go through some automated review process and then get basically an electronic notification that they are licensed within 24 or 48 hours, if it is a clean application. If it is not clean, if there are disciplinary issues, then it goes to the state to decide what to do with it.

But in order to do that, you have to have a certain amount of uniformity in the system. You have to have uniform applications, uniform lines of authority, and there are some minimal elements. And we are getting those pieces in place that are critical to do our national non-resident licensing system. And we now have I think 15 states online doing non-resident licensing. We have processed over 2,000 non-resident licenses this year already through our non-resident licensing system. And our goal was to have 35 states on board by the end of the year.

Mrs. BIGGERT. So on the rate and form filing, how many products have been approved under this mechanism?

Ms. VAUGHAN. CARFRA has been kind of an interesting animal. The intent when we built CARFRA, that is our streamline coordinated rate and form review system, the intent was to build a system that would allow for coordinated review, that would allow us to do a speedier review, that would allow us to set national standards so that we could identify state deviations against those standards and really streamline the process. And we did that last May. We went online with 10 states and three products.

And the good thing is that the products that have been filed with us, we have done the review, we have done it very quickly. Everybody has been happy about how it has worked. The sort of disappointment, I think, is that we have only gotten two filings so far. It is clearly not what we expected. We thought that this was going to be something that people would jump on board with. And, as we spent the fall dealing with the events of September 11th and dealing with what we were seeing emerge in CARFRA, we were trying to understand what was holding CARFRA up, the success of CARFRA.

And it appeared to be a number of issues. In the companies, there were certain sort of cultural issues. They were used to doing it one way and one has to get past that, not just in the regulatory side but also on the company side. Second, there was some technology issues. They needed to have our electronic system up and running in order to do it. Issues about which lines of insurance were chosen.

But I think the main thing came down to the deviations that were in place. We had 10 states. Two of those states, New York and Texas, had a significant amount of deviations. A number of the other states had a couple, but that is really what led us to focus on the sort of the next stage of CARFRA, evolving CARFRA into something that would allow us to deal in a very systematic way with the problems of deviations and getting to more uniformity in the standards. And that is where we have gotten to the interstate compact.

Mrs. BIGGERT. Thank you. Thank you, Mr. Chairman.

Chairman BAKER. Thank you, Ms. Biggert.

Mr. Bentsen?

Mr. BENTSEN. Thank you, Mr. Chairman.

Mr. Milesko, in your testimony, in talking about the optional federal charter, you talk a lot about the upside in terms of bringing product to market and developing product for the benefit of the consumer and doing it more quickly. But I am a little concerned in your discussion with respect to consumer protection. And I have to say I sort of agree with the idea of a federal charter. But I think that—I am concerned that your proposal or your association's proposal is a little light when it comes to consumer protection. And you stated in response I think to Mr. Ross that federally-chartered insurers would still be subject to state laws. But in the summary, in your testimony, it seems to state otherwise, that once you opted for a federal charter, you would be under a federal charter and there is not necessarily any parity provision that would carry state laws or federal laws the other.

And Mr. Ross had the concerns about the 11,000 employees and the state regulators and how big is the federal regulator, I don't particularly care about how many employees there are one way or the other. But our experience has been with the federal banking regulators, that they have not always been the most effective consumer protection regulators at the retail level. And I tell you this just because I think it is something you all need to think about.

I think, quite frankly, Mr. Van Osdall's testimony is some of the best testimony I have read on this subject because I think your group has started to wrap this all together, of saying if you are going to have a federal regulator, fine, but you need to have some connection between the federal regulator who is looking at the national market with state regulators or someone who is looking at the retail market vis-a-vis how the securities market works.

And you talk about NARAB as being some form of a SRO. And I really think you need to consider that both from a policy perspective and arguably from a political perspective as well. Because I think that while you are right, that having the flexibility to bring product to market, the flexibility to license will benefit the consumer in that regard, it concerns me that it is just a lot harder to get the Federal Government to respond on a retail consumer complaint than it is to a state regulator. And it is something that I think you all need to go back and take a hard look at your proposal and how you are developing it.

If you look at what Mr. Ahart is proposing, it is just amazing how it is moving the direction because he is talking about a federal preemption, I assume, using federal statute to preempt and create a de facto federal system run by the states.

So I think even the independent insurance agents understand the necessity for some sort of federal structure. But I am just concerned that your federal charter system doesn't go quite far enough.

Mr. MILESKO. I think we need to look at that. I think that that makes a lot of sense. I think that having a federal charter, though, would eliminate some of the issues that you have currently like with the Franko case as an example, where the individual, Franko, was not—

Mr. BENTSEN. I read your testimony. It wasn't detected necessarily as quickly, although the banking regulators have not always been on top of the issues as well.

Mr. MILESKO. Right.

Mr. BENTSEN. And the other thing is—and, again, I tend to agree with your position in the abstract, I think also the comparison that the OCC—using the OCC comparison, remember, as you well know, the OCC is not the only regulator of national banks. The FDIC is also a regulator of national banks and looks at safety and soundness. So I just think you need to go back an take a hard look at that.

Mr. MILESKO. Let us get back to you and take a look at that.

Mr. BENTSEN. Appreciate it.

Thank you, Mr. Chairman.

Chairman BAKER. Thank you, Mr. Bentsen.

Dr. Weldon?

Dr. WELDON. Thank you, Mr. Chairman. I had a question for Mr. Ahart. I thank you for your testimony. I wanted to get an opinion from you regarding—my question is would a federal charter perhaps benefit high-risk states, as I represent Florida and we pay very, very high, understandably, premiums for property casualty insurance. Do you feel that a federal regulator would be perhaps better able to provide the necessary oversight and market sensitivity to what is going on in states like Florida? Your opinion there?

Mr. AHART. Sure. Actually, I am almost a brother in there, I guess, because I come from New Jersey and we have very high rates in auto insurance. So I can feel the pain. I think that a federal charter program would not help that situation at all. I think the issues in New Jersey and Florida can best be dealt with and understood by someone in Florida and someone in New Jersey and someone that deals with that every day. Again, to me, a federal chart is really overkill. And I am not sure why we would handle—if we have specific issues involving market conduct, speed to market, things like that, I am just not sure why we wouldn't just attack those issues rather than replace the whole system.

Again, I just think that somebody in those states can best see those problems better than somebody from Washington, D.C.

Dr. WELDON. Do the other three witnesses agree with that or disagree, or do you want to comment on it at all?

Yes, Ms. Vaughan?

Ms. VAUGHAN. I would be happy to comment. I think this demonstrates some of the differences between banking insurance that Congressman Bentsen was identifying and that is there really are some local issues and there are some significant consumer protection issues involved in insurance. There is nothing more frustrating to me than to hear some of the proponents of an optional federal charter say it works in banking, therefore it can work in insurance, because as an insurance regulator, I know that there are very significant differences between banking and insurance, and the fact that we have to deal with things like hurricanes and earthquakes and they vary across the country and we have different auto insurance systems and we have things in New Jersey that are driving auto insurance costs that don't exist in Iowa, where we have the lowest auto insurance rates in the country.

And so we have very different markets. And I would agree that I have a hard time seeing how a federal, an optional federal charter could solve the market problems that you have in Florida that exist because of the geographic issues and the weather-related issues that you face.

Dr. WELDON. Yes, Mr. Osdall.

Mr. VAN OSDALL. I think your comment also embraces the whole idea that at some point there needs to be cooperation between both the federal and state level to solve some of the issues we deal with and a hurricane may be one of those issues, an earthquake may be one of those issues. Certainly, terrorism on the table today is one of the great issues. Without the federal influence, without a federal solution to the terrorism issue, we would be nowhere because what the states have generally done is accepted the terrorism exclusions that are represented by the insurance companies. So I do think there are those legitimate areas where we have to have the co-operation and the support of the Federal Government in the insurance industry.

Dr. WELDON. I thank you, Mr. Chairman. I yield back.

Chairman BAKER. I might take that minute just for a point of clarification from the commissioner. By way of current body of law in consumer protection, let's assume for the moment that a Louisiana Congressman buys an annuity from a New York company. He then is retired, moves to California, where he is deceased. His heirs live in Wyoming and South Carolina. And the company refuses to give them their money. If I am understanding the law correctly, Louisiana law applies, which is the only state, not common, law, civil code, that you would either have to litigate it in a common law court using Louisiana law or hire a Louisiana counsel and fly everybody to Louisiana to litigate the issue. Now, tell me, how simple is that?

Ms. VAUGHAN. Not simple. And I am not a lawyer, so I won't pretend to understand how this legal system would work. But I think what this demonstrates also is insurance is very complicated and that the issues in life insurance are fundamentally different from the issues in auto insurance and homeowners' insurance and commercial lines insurance, and medical malpractice. We have not one insurance market but multiple insurance markets.

In life insurance, annuity insurance, disability insurance, and long-term care insurance, people buy long-term products. They move from state to state. That is different from auto and homeowner's, where you buy a product and it covers you in the state in which you live for one year or six months and then you renew it where you are.

Dr. WELDON. Mr. Chairman, can I reclaim my time? I want to ask a follow-up question to what she just said.

Chairman BAKER. Sure, absolutely.

Ms. VAUGHAN. Can I finish just one second?

Dr. WELDON. Yes, go ahead, go ahead.

Ms. VAUGHAN. I was going to say in life annuity, disability, and long-term care, that is why we have agreed, the commissioners have agreed, that we need to have more uniform national standards to address the issue, the fact that people move from state to state. And we agree with that. That is a different problem, but it is not the classic problem affecting all insurance markets.

Dr. WELDON. Okay, well, I think you partially answered my question. But my question was a federal charter for auto is going to illicit more of a negative response. A federal charter for property casualty is going to elicit more of a negative response than a federal charter for life insurance is what—because the case he made is a very good case.

Thank you, Mr. Chairman, for your indulgence.

Chairman BAKER. Oh, certainly. Please proceed, Commissioner.

Ms. VAUGHAN. Thank you very much. I think we have property casualty insurance. We have life insurance. We have very local issues in property casualty insurance. And the reality is you don't have nearly as many local issues in life insurance. I would agree with that. The risks that life insurers assume, mortality risks, interest rate risk doesn't tend to vary from state to state. Consumers move from state to state.

And so we agree that you need some kind of national uniformity in life insurance. The problem is that we don't want to throw the baby out with the baby water. One cannot create a federal regulatory system in Washington without impacting the important consumer protections that we have in place, without impacting the property casualty side in the industry. So the question is can we find a targeted solution to get to national product standards in life insurance and annuity insurance, which we agree we need, without gutting the rest of the system? And that is what led us to the interstate compact.

Chairman BAKER. Thank you very much. And I want to express my appreciation to all of you for your contributions. It has been a very helpful hearing. We appreciate your remarks. The record will remain open for an additional 30 days—oh, I am sorry, Mr. Rogers, I didn't see you. Mr. Rogers?

Mr. ROGERS. It is the price you pay for being a new guy, Mr. Chairman.

Chairman BAKER. Or for not being here.

[Laughter.]

Mr. ROGERS. Well, it is good to see you, Mr. Chairman. Doesn't he look handsome today, everybody?

[Laughter.]

Mr. ROGERS. I want to also thank Commissioner Vaughan; not being a lawyer and being from Iowa really ranks up there. Your credibility is fantastic around here.

Mr. Ahart, I wanted to ask a question. You talked about in your proposal preserving state regulation while having Congress act to reform the state insurance regulatory system. And you mentioned specifically speed to market. And I am curious if you can explain how you can do that and still address the issue of speed to market within the confines of that what seems like a contradictory—

Mr. AHART. Sure, what we would is use again federal legislative tools. We would have federal legislation that would preempt state rights on the issues of forms and rates. So we would pretty much recommend adopting, similar to the Illinois model, where states would have to follow a file and use provision on forms and have only 30 days to review. Where on rates they would be able to—companies would file but would automatically be able to use them in competitive markets. So that by having those uniform standards, states would need to use those but it still would be regulated from the state level.

Mr. ROGERS. Great. I just want to follow up with Mr. Milesko on that same vein. We have got about 7,400 state legislators across the country, which should send shivers up your spine with regulation. And I was one of them on the Financial Services Committee. We have heard from the different witnesses regarding the challenges facing state legislators in uniformity and speed to market and agent licensing. And as we kind of move forward, what do you think is the proper role for Congress to address those issues?

Mr. MILESKO. I think the dialogue that we are having today, roundtable discussions, I think is very appropriate to get these issues on the table. They will look at the merits of all the proposals. Now, we certainly would defend the optional federal charter, which leaves the state system as it is and just overlays a federal system on top of that.

Mr. ROGERS. I yield back the remainder of my time, Mr. Chairman. The handsome, very handsome chairman of the committee.

Chairman BAKER. Very helpful member, I might add. Thank you very much, Mr. Rogers.

I want to thank each of you for your participation here this afternoon. It has been very helpful. And the record will remain open for 30 days for any additional comment. And I forgot, Mr. Kanjorski wants another minute.

Mr. KANJORSKI. I just wanted to make the point, we were talking about the various states. I am not sure, but some states elect their state insurance commissioners, and others are appointed. If any of the members would like to express an opinion, if we go to a national charter, are we going to create another national office of national insurance commissioners who run along with the President, or do you think that an appointive Cabinet position? I really want your opinion on the election process in various states and how that impacts on some of the problems that we see in the insurance business on the state regulatory level.

Mr. VAN OSDALL. I would like to offer comment on that. The elected position, without having the background in the business and the training and understanding, I think, has been one of the things that continually slows down those very issues that we are trying to address and tackle. You can almost look at it state by state and when it becomes an elective position, which is often a stepping stone to another position, you have a transient person filling that job in many cases. And that has been a real detriment to insurance regulation, I think, over the years.

Mr. KANJORSKI. Yes?

Ms. VAUGHAN. I am not going to take a position on which is better. I happen to be an appointed commissioner, and I am proud to be an appointed commissioner. And I have very fine colleagues who are elected commissioners. And I think we have had some very fine elected and appointed commissioners. But I think what this reflects is the idea of local control. And the citizens in Kansas have decided that an elected commissioner is what works for them. And the citizens of Iowa have decided that an appointed commissioner is what works for them.

Mr. KANJORSKI. But if the Federal Government takes up the position that we are going to overpower the states and create a federal charter, we are going to decide what now is covered by an elected official will be covered by an appointed official?

Ms. VAUGHAN. You are overriding the decisions that are made by the citizens of those states with respect to the markets in their states, by the legislators, the state legislators, the elected commissioners, and whoever is in there working on the state insurance market issues.

Mr. KANJORSKI. Is that an argument against having a federal charter?

Ms. VAUGHAN. I would say that there is a question—it gets back to the question of whether a federal regulator can best understand and create a regulatory environment in Iowa when they are based in Washington, D.C. and they don't understand our Iowa markets and our Iowa consumers and our Iowa issues. So this is all about—one has to go back to this is all about consumer protection. The reason that regulators exist is consumer protection. And the question is what is the best way to frame that consumer protection. And we at the NAIC believe that regulators that are local, given that so much of insurance issues are local and so many of the issues that consumers deal with come at times of crisis and stress, things that we have to help consumers with—their house burned down, their company is not paying for it, their child needs an operation and the insurance company won't pay for it—that these are things that local people are best able to respond to.

Chairman BAKER. Thank you, Mr. Kanjorski. Another issue that has to be resolved is the term that someone would serve. In Louisiana, for several commissioners it has been 20 years to life. So that has to be worked out.

[Laughter.]

Chairman BAKER. I would like to thank you again and excuse this panel so we may hear from our next gathering of witnesses. Thank you very much.

I would like to welcome each of our participants to our second panel and certainly appreciate your willingness to appear here today. Our first panelist is Mr. Scott A. Gilliam, who is Director of Government Relations, Cincinnati Insurance Companies.

Welcome, Mr. Gilliam.

STATEMENT OF SCOTT A. GILLIAM, DIRECTOR OF GOVERNMENT RELATIONS, CINCINNATI INSURANCE COMPANIES

Mr. GILLIAM. Thanks, Mr. Chairman, Ranking Member Kanjorski, and members of the committee. I am with Cincinnati Insurance Company. We are a property and casualty and life insurance company. We operate in 31 states, with a premium volume of about $2.5 billion a year and a million policies in force. So we are not the biggest but we are not a small county mutual.

I was asked to talk about consumer protection issues today and how they impact the question of whether insurance regulation should remain a state-based system or whether a federal approach to insurance regulation should be considered.

My first point today, already touched on by some of the first round of questions, consumers are served best by state regulation. For consumers, the strength of the state-based system of insurance regulation lies in its ability to respond to consumers, to adapt to local market issues, and to enable states to experiment and learn from each other. State insurance commissioners become experts in the individual state issues they face, enabling other commissioners to learn from their experience. In this way, the insurance regulatory system evolves to meet new challenges. Accessibility is another advantage that state insurance regulation has over the federal regulation insofar as consumers are concerned. No one can quarrel with the fact that it is easier to deal with regulators in the consumer's home state than by having to call 1-800-Washington in order to get help with a consumer insurance issue.

The accessibility of insurance regulators to consumers would suffer under an optional federal charter system given the likelihood of consumer confusion with the two systems. Under an optional federal charter system, state-chartered insurers and federally-chartered insurers would operate side by side in the states. Under those circumstances, consumer access to regulatory protection would be needlessly complicated by the mere existence of dual regulatory systems and the resulting confusion as to which system has jurisdiction over a particular consumer complaint. Insurance consumers should not have to roll the dice when deciding whom to contact for a problem.

The warning made by Chairman Oxley in his opening statement last week, that consumers cannot be adequately protected if insurers are subject to conflicting requirements at the federal and state levels, seems equally applicable to the situation insurance consumers would face with conflicting federal and state consumer protection systems.

It is also doubtful whether the Federal Government would have the resources and expertise necessary to effectively and efficiently protect insurance consumers. It would take a huge effort to duplicate the activity of the states in this regard. Consider two key facts. In the year 2000, insurance consumers made approximately four million consumer inquiries and complaints to state regulators. State insurance regulators employ 12,500 regulatory personnel nationwide and those departments spend $853 million annually to be the watchful eyes and helping hands on consumer insurance problems.

We feel the Federal Government is simply not equipped to take on such a role and develop a regulatory authority for insurance consumer protection as sophisticated and widespread as the state system that has been 200 years in the making.

My next key point, the benefits of state regulation to insurance companies also benefit insurance consumers. The benefits of the state insurance regulatory system on insurance companies also translate into benefits for insurance consumers in the form of competitive markets. Let's consider a few examples.

Unique knowledge of markets and local conditions. States are the only logical choice for the comprehensive regulation of insurance given their unique knowledge of local markets and conditions. State regulators know the insurance markets within their borders. Although there are uniform national concerns in the industry, as in many others, in uncountable ways insurance involves concerns of an intensely local nature. The concerns in Ohio, for example, with its multiple urban centers, lakefront communities, and manufacturing base are quite different from the insurance issues raised in Iowa with its thousands of farmers and few large urban areas.

Less risk of regulatory mistakes. Under state regulation, good regulatory initiatives spread to other states and conversely the bad ideas tried in one state prevent others from making the same mistakes by offering real market examples. Having 50 different regulators is less risky than gambling on a single federal regulator who might have an axe to grind against the insurance industry and ultimate power over the industry to swing the axe.

Another example: State regulation encourages innovation. Insurance companies often use a particular state as a laboratory for testing new product ideas or competitive strategies before they are introduced on a national level. Good products and good competitive strategies in one state often spread to other states. Likewise, unsuccessful strategies in one state often educate the rest of the industry and lead to better products and more competitive markets in all the states.

So where are we today? While state regulation of insurance has worked very well, the realities of changing market conditions, including globalization and financial services convergence and consolidation demand a more efficient regulatory system, including greater coordination and consistency across the states. While some are calling for federal regulation to address the changing face of the insurance industry, we feel state regulation still works best.

At the same time, we realize that in order to preserve state regulation during these changing times, the current system of state-based insurance regulation needs to be modernized, streamlined, and made more efficient. We have already heard about the strong and growing effort underway within the National Association of Insurance Commissioners to modernize state insurance regulation and it appears a national regulatory agenda is taking hold.

But there still remains work to be done. We would be remiss if we did not acknowledge that the efforts by the NAIC to modernize state insurance regulation are only a start. Virtually every area of insurance regulation needs to be improved if the state-based system is to meet the challenges of a modern insurance market. But unlike those companies who would abandon the state system and start over with federal regulation or dual regulation, the Cincinnati insurance companies are committed to doing the hard work needed in the state capitals to modernize, streamline, and increase the efficiency of state regulation.

Two more quick points and I will conclude. What if the states do not follow the lead of state insurance regulators and the NAIC and enact the reforms needed to modernize state regulation or do not act soon enough or do not do enough to re-invigorate state insurance regulation? In this event, our company is intrigued by the possibility of using federal legislation to encourage the states to undertake more rapid and comprehensive reform of state insurance regulation. While we are yet undecided on the form such legislation would take, we would prefer a model that would allow the NAIC to be active in crafting the reform legislation states need to enact to avoid federal regulation.

In suggesting that Congress consider the use of federal legislation to encourage reform at the state level, we are mindful of the dangers incumbent in opening these issues up for federal legislative debate. And while we recognize these dangers, we believe that using federal legislation to encourage reform at the state level as a last resort is certainly better than jumping hook, line, and sinker into a federal system of insurance regulation.

My final point this afternoon, my company feels that state regulation is the preferred model of regulation for all lines of insurance, property, casualty, and life insurance. Many in the industry think of my company as a property, casualty company only, but we do have a significant life insurance operation with over $100 million in premium a year. In fact, our life subsidiary, Cincinnati Life Insurance Company, is a former member of the American Council of Life Insurers. I bring this to your attention in reply to what seems to be the growing refrain in Washington, that we should not think twice about lobbing off the life industry and handing it over to federal regulators. My company strongly disagrees with this point of view and believes that state regulation works best for all aspects of the industry, including life insurance as well as property and casualty. A reform system of state insurance regulation for all lines of insurance, including life, is far superior to an unproven system of federal regulation.

Thank you.

[The prepared statement of Scott A. Gilliam can be found on page 344 in the appendix.]

Chairman BAKER. Thank you, Mr. Gilliam.

I take particular pleasure in introducing our next witness, Mr. Hans Sternberg, a long-time friend and resident of Baton Rouge, Louisiana. More importantly, he and his wife, Donna, have been accomplished business people and very civic-minded in their work within the community. So it is a pleasure to welcome you here today in your capacity as chairman and CEO of Starmount Life Insurance Company. Welcome.

STATEMENT OF HANS STERNBERG, CHAIRMAN AND CEO, STARMOUNT LIFE INSURANCE COMPANY

Mr. STERNBERG. Thank you, Mr. Chairman.

Chairman BAKER. You have to hit the little button on the front of the mike. It is not on.

Mr. STERNBERG. Thank you, Mr. Chairman, Ranking Member Kanjorski, and members of the subcommittee. My name is Hans Sternberg. I am chairman of Starmount Life Insurance Company. We employ 63 people and are admitted in 18 states. I am here to offer my perspective as the owner of a small family business. In fact, four years ago, when our premiums were under $4 million, I boasted we were America's smallest life company. This year, premiums will exceed $18 million. Obviously, still small, but growing.

I spoke to Chairman Baker about the optional federal charter to be sure small independents are not excluded by high capital or revenue minimums. Companies like mine need this legislation because the present system imposes high regulatory costs and restricts market access. Regardless of size, all companies pay the same dollars to comply with legislation—regulation. Thus, smaller companies bear a higher percentage cost than larger ones. To Geico, which testified here just one week ago, $100,000 is pocket change. Not to companies like Starmount.

One of our divisions sells life insurance by mail. The economics of direct mail selling assume we reach all names on productive mail lists. Unfortunately, barriers to entry in many larger states makes this impossible. Conversely, we generally avoid the 12 smaller states, like Delaware, North Dakota, Idaho, Montana, Wyoming, and Rhode Island, with 2 million people or less, because the costs of regulation make it difficult to be profitable there.

Not only is Starmount barred from many larger markets, but citizens of both state groups lose the competitive benefits new companies bring. For example, greater product choice, lower prices, better service.

Here are other examples of what we face. One, for several years we bought insertion privileges in the Visa monthly bills of our local bank, which allowed us to send marketing material to the bank's several hundred thousand Visa cardholders. It was our most profitable venue. Then the bank won a 50-state military contract. We lost all opportunity to continue selling through the bank because the bank needed a company which could serve all its customers. There was no way to replace that business.

Two, we once developed a policy at a cost of $20,000 to $25,000, which is a lot for a company our size. It was approved in all our states except two. After three years, we abandoned the program. It is not economical to promote to only part of our customer base, plus there is the constant fear of mailing to the wrong jurisdiction.

Three, for years we ran a newspaper ad in several states but one fined us $10,000. That state has a unique rule we didn't know about. If you show even one rate in an ad, you must show all rates. That would have meant 188 of them. We obviously no longer run ads in that state, but such foolishness is solely political protection for entrenched marketers who oppose competition.

Four, at one time we used brochures to sell in supermarkets. The distributor inadvertently sent the one state's material to some Wal-Mart stores. The insurance was approved by both states, but the minor differences caused a $7,000 fine. We stopped using brochures in grocery stores, so the consumer lost that option.

Five, we have insurance product filed for two and a half years but not yet approved in every state. The excessive delay is expensive and frustrating. In the end, the consumer has less choice.

Six, our largest division uses agents to sell supplemental health benefits to companies. To take advantage of a 50-state opportunity offered us by a major national retailer, we recently partnered with a national carrier, giving half the potential sales to the partner. For us, it is better to have half the business rather than none. But the sales relinquished by us will involve millions. Over the next two years, licensing for this program will cost over $100,000.

The present system will always handicap Starmount's efficiency. We are forced to charge the consumer more as well as to fall short of our sales potential because of unnecessary and inconsistent legislation and regulation.

I hope this committee remembers the small companies which regularly encounter these bureaucracies.

Thank you for this opportunity.

[The prepared statement of Hans Sternberg can be found on page 398 in the appendix.]

Chairman BAKER. Thank you very much, Mr. Sternberg. Our final panelist is Mr. Wayne E. McOwen, Vice President of External Affairs, Guard Financial Group. Welcome, sir.

STATEMENT OF WAYNE E. McOWEN, VICE PRESIDENT OF EXTERNAL AFFAIRS, GUARD FINANCIAL GROUP

Mr. MCOWEN. Thank you. Chairman Baker, Ranking Member Kanjorski, and members of the subcommittee, my name is Wayne E. McOwen. I am senior vice president for government affairs and industry relations for Guard Financial Group.

I thank you for the opportunity to offer comments, and I join my industry colleagues in applauding your commitment to insurance regulation reform. Guard Financial Group is engaged in the full financial services arena of insurance, banking, and investments. Accordingly, we are subject to multi-state, as well as federal, regulation.

My purpose today is to offer observations on the advantages of choice. As requested, my comments will address the regulation of insurer business practices and issues of regulatory choice and regulatory competition.

State regulators scrutinize the financial viability and business practices of insurers through a process of examinations. Such exams are conducted routinely at scheduled intervals but can also be triggered by circumstances. The primary public policy objective or regulators is solvency. The financial exam focuses on insurers' adherence to universally-accepted financial standards. The process is as precise as mathematics.

Whereas there is consistency to the focus on the objective components of an insurer's financial health, the evaluation of business practices or market conduct is neither universal nor uniform and can be somewhat subjective. Consumer protections are a priority of state insurance regulators, yet the process is complex, costly and rife with inconsistencies that limit its benefits.

Especially problematic is the interpretation of regulations; what are considered fair business practices or arbitrary or capricious actions in one jurisdiction may not be in another. Sometimes variations of the same requirement are problematic, such as when performance benchmarks differ for no apparent reason. Consider coverage cancellation rules, for instance. There is no clear rationale for why policy holders of one state are accorded a 30 or a 45 day notice or more while those in another state receive only 10. With postal services standard country-wide, this patchwork of delivery notice rules seems unnecessary and only confuses consumers, particularly multi-state commercial policy-holders for whom such rules may have different business consequences.

The market conduct process is by design duplicative. Carriers are subject to the scrutiny of regulators in all states of operation. Exams conducted by one state may be duplicated by another to evaluate identical business practices. Duplicative exam fees and the down time of staff engaged in the process raise the cost of doing business and fragmentation can exist even within the same state when two or more agencies share regulatory responsibilities.

For more than 100 years, the dual regulatory system has worked successfully for banks. Applying a similar model for certain insurance operations portends all the benefits derived from choice.

Choice, America was founded on it. Competition, America thrives on it. Why, then, is the prospect of regulatory choice for insurers and competition between state and federal regulators so difficult to accept? Admittedly, an optional federal charter does not have universal appeal but the operative word here is optional. For insurers doing business in a multi-state arena or for those marketing a limited number of products with consistent risk factors, a streamlined federal regulatory process portends a wider selection of more innovative and competitive offerings. Simply stated, regulatory choice for insurers translates to more choice for consumers.

The National Association of Insurance Commissioners is to be commended for its leadership and resolve toward the uniformity and consistency of state regulation. But without an impelling incentive, expect the process to continue to move slowly.

Here are some compelling reasons to accelerate the process: The demands of an expanding global economy; increasing strains on insurance from a complex legal system; providing viable insurance products via e-commerce; federal initiatives such as the Patient's Bill of Rights and the pending Health and Human Services medical privacy rules all boast arguments for a centralized authority in certain circumstances.

Providing the insurance industry with a strong national voice does not require reinventing the wheel. A system of federal and state regulation should be neither exclusionary nor duplicative but simultaneous and complementary. Ideally, it would identify the best practices of state regulatory systems, precisely the process engaged by state regulators in crafting model laws aimed at encouraging uniformity. But encouraging it is not the same as requiring it. A federal regulator could have the tools to make it happen.

Finally, our preparedness to meet the far-reaching and extraordinary challenges of possible further terrorism events illustrates the key role of the Federal Government. Stakeholders did not approach 50 states for a solution to terrorism insurance, they went directly to Washington. The founding fathers were judicious in crafting a federal umbrella that would not impair states rights. Their goal was to strengthen the system by bringing structure and unity. More than two centuries later, we struggle with this concept and its application to the regulation of insurance, a mechanism that the events of September 11th reaffirmed is so critical to our economy and to our lives.

Thank you.

[The prepared statement of Wayne E. McOwen can be found on page 350 in the appendix.]

Chairman BAKER. Thank you very much. Again, this panel has also been very helpful.

Mr. Sternberg, I found the examples you cited, the regulatory inefficiencies, to be quite troubling, and frankly, those are the kinds of examples that the committee needs to understand better; the fact that you are licensed in two adjoining states and had marketing material reversed and still found yourself financially liable I think points out some of the difficulties of the current system.

To that end, we have had earlier testimony in another hearing in which a CEO of an insurance company indicated that they had withdrawn and would not return to the state of New Jersey primarily because of the regulatory complexities within the state. That leads me to remember a conversation you and I were having earlier with regard to the size of the industry today versus a year or two ago. Could you give the committee that information, on what is happening in the marketplace from your perspective?

Mr. STERNBERG. Yes, I actually can. I did a little research before I came up. Five years ago, there were 1,748 life insurance companies in this country. Today, there are 1,454. That is a drop of 16 percent. I understand something similar—that is for life companies only—I understand something similar is happening in the P&C industry. And part of that is normal consolidation, but also, a lot of it is because companies are struggling to make a profit. The ROE, return on investment—on equity—is not good in the life insurance company—industry. It doesn't approach the banking industry. And we are suffering because of it. And you are going to see more shrinkage.

Chairman BAKER. And would the likely outcome of this, as capital formation and start-up costs are difficult, if you were in business and approved in all 50 states, had your regulatory costs behind you, wouldn't it make sense from a business perspective that companies who find themselves in that posture not to be too excited about lowering regulatory barriers because you might have a Starmount coming around the corner?

Mr. STERNBERG. Well, certainly. We would be twice as large today if we could operate in more states or significantly larger. And there are some entrenched feelings on that, sure. But I would assume most of the larger companies would prefer to have a national charter also, though I am not aware of the testimony on that.

Chairman BAKER. Thank you.

Mr. Gilliam, I have asked other panelists along the day and over the course of the few weeks their view of the Illinois system which in my judgment is sort of the other side of the coin in this process where you file and you don't have to even have rate pre-approved and it seems to be working fairly well there with a lot of competitive product at pretty good prices for folks in Illinois as opposed to New Jersey where you have insurers trying to leave the market. If we were to try to come to some agreement, and I am just fishing for less volatile territory here, particularly on the life insurance side, the advisability of a national location for your filing similar to the Illinois structure, leaving consumer protection to the states. I see the viability of having someone local to call, some local point of accountability if you are defrauded or have difficulty in getting settlement but doesn't the logic of having more competition make a great deal of sense from a consumer perspective, forget property and casualty, forget automobile because they are more difficult. Do you still have the same objections if you go in that narrow of an approach?

Mr. GILLIAM. Just so I am clear, are you just talking about life insurance products now?

Chairman BAKER. Yes.

Mr. GILLIAM. I would echo the remarks of Commissioner Vaughan when she was asked a similar question. Clearly, there are less differences in the nature of life insurance products than P&C products on a national basis. I have heard some say a life insurance policy is a life insurance policy in Florida, Iowa, or Washington state. But I guess what I would say is I see the point there, our view is that if the same uniformity in terms of product approval and so on is there to allow a company like his to file one product and have it approved in all 50 states simultaneously, I think that is a great thing.

But I guess we would say if the states can do that—and again, that may be a big hurdle because they haven't come that far yet—but if the states can do that, why not have them do it, versus going to a new, untested national or federal situation?

Chairman BAKER. Though I guess my response to that would be in your best judgment, if all things worked well, how long is it going to take us to get to a uniform system even with regard to life, much less everything else?

Mr. GILLIAM. That is the $64 billion question. How much time do we give the states to do this? How far do they have to go before we say they have met their charge? Is it like a NARAB system where when a majority of states do it, it is okay? I don't think that probably works, because a system where 29 states of 50 do something is not like having a national system. And I guess I would add on that is why we are intrigued by the idea of using some federal legislative authority to urge the states to action. It is clear that the states have to act and modernize. This is not going to be an issue that is around for 20 years, like Gramm-Leach-Bliley. There is too much at stake in terms of the changing face of the marketplace. It has to be addressed in the next five, ten years at the very latest.

So I can't tell you how long it is going to take the states. But our view is let's give them a shot. If they don't look like they are reacting, let's put some federal onus on them. And at the end of the day, if they can't do it, then we may have to rethink things.

Chairman BAKER. I think that is much of the thinking here. We had hoped that NARAB would be the shot. We had hoped that we could see more positive development with regard to premium dollars regulated. But it just doesn't seem to be moving very well. And I guess we have to come to some decision about how much longer can we wait and then explore in the meantime whether an Illinois-like model doesn't make a great deal of sense at least in some product lines, reserving consumer protections to the state. That to me doesn't seem to be on the edge of irresponsibility at least.

Mr. GILLIAM. And I did fail to mention that we also jump on the Illinois bandwagon. All of us in the industry love the way things are done in Illinois, but with all due respect, it is also done well in the great state of Ohio.

Chairman BAKER. Well, I certainly have great regard for the state of Ohio, sitting on this committee, and would look at that very advantageously.

Mr. Kanjorski?

Mr. MCOWEN. Excuse me, Mr. Chairman, may I comment on that last question?

Chairman BAKER. Certainly, yes.

Mr. MCOWEN. I think there is another issue to the licensing of products. One doesn't just file to be approved to sell a product in the state. First, a certificate of authority has to be obtained from that state. One has to be licensed to do business. And there is a great deal of inconsistency in terms of state approval of companies to do business. And whereas I indicated in my testimony that the financial benchmarks are fairly universally accepted, it is nevertheless true that although you might be licensed to write business and accepted to write business in one state, you may not be accepted as readily in another state.

Having then gotten the license, another issue, of course, as mentioned, is filing those products for acceptance.

Chairman BAKER. Thank you very much.

Mr. Kanjorski?

Mr. KANJORSKI. Mr. Chairman, I have been listening to the witnesses today and, of course, Mr. Sternberg surprises with a small company like that asking for a national charter. That is really gamesmanship in terms of wanting to get out there to compete. That is great.

There was one suggestion on the earlier panel about using SROs, self-regulatory organizations. And perhaps we could expound on that to think about that as the entity to create uniformity of policies, language policies. Even dealing with the rates in some way or methodology of setting rates.

What I am most interested in, having been here maybe too long, is whenever the Federal Government reaches out its arm to help, it generally has its other hand out to extract a price. And in the insurance industry, that could be an extraordinary price.

As Mr. Gilliam knows, we worked on catastrophic insurance not too many years ago. And when you analyze what was attempting to be done legislatively was to force the residents of Idaho to pay a premium to cover the residents of Florida against hurricanes. It was looking at a national problem of disasters and saying the residents of that one area or the present based were insufficient to cover the risk so that we wanted to enlarge the base nationwide. Either use it by adding on to the premiums and surcharging premiums across the board or the Federal Government using the base of the taxpayers to stand the expense that was unique to a single region or a single state.

I am just wondering have you given some thought—maybe Mr. Sternberg, I will direct it to you first—would you be disappointed if the Federal Government says that if we are going to allow you to write insurance nationwide, that we also are going to require you to charge a uniform premium or to write in the states of New Jersey and Massachusetts, which seems to be nobody's desire at this time, for some reason or another. But can't you envision the time when politically a President of the United States will direct his cabinet officer or Members of Congress would get together and say, "Boy, the big state of Massachusetts and the big state of New Jersey have a problem in auto insurance, and we want the federal commissioner to direct all P&C writers that they have to write in these states even though they take a loss."

Mr. STERNBERG. Of course, I am a life company.

Mr. KANJORSKI. I had an example for your company. Let's suppose that longevity in Pennsylvania is average 85 years of age but in L.A. it is only 65 because of smog. Would you want to have to charge and offer the same premium in L.A. as you would in Pennsylvania?

Mr. STERNBERG. Yes, that would not in the life industry create a major problem. The price-fixing that I thought I heard you say, price controls have never worked. And they didn't work in the Nixon administration, they won't work here.

Mr. KANJORSKI. How would we set the rate on the life insurance if you had a life expectancy in L.A. of 65 because of smog and a life expectancy in Pennsylvania because of the beautiful weather of 85?

Mr. STERNBERG. Well, I think it would work even better than it works in a constricted marketplace as you have now. You would have a lot of people out there—

Mr. KANJORSKI. You would charge different premiums based on the state lines?

Mr. STERNBERG. Well, that isn't quite the way we do it in the life business. We are in 18 states and what we do, we base it on the health of the individual and our own products and our own cost structure.

Mr. KANJORSKI. But isn't there an environmental factor as to where you live, the impact on your life expectancy?

Mr. STERNBERG. Not that we have come across, no, sir.

Mr. KANJORSKI. There isn't any?

Mr. STERNBERG. It has to do with health. For example, if we have an American citizen who is living in Africa 10 months out of the year, we will not insure that person. But if we have a foreign person who is living over half the year in the United States and getting their health care here, we will. So it is where you get your health care that would determine.

Mr. KANJORSKI. But you wouldn't see any difference in life insurance of insuring someone in a smog city like L.A. as compared to Iowa, nice fresh country air?

Mr. STERNBERG. The only thing we would pay attention to is crime. If it is a high-crime area, we generally tend to avoid it. Otherwise—

Mr. KANJORSKI. Then you wouldn't write the policy?

Mr. STERNBERG. We would not write the policy.

Mr. KANJORSKI. Then maybe that gives me the example. But the federal commissioner says L.A. is a very important town for votes and we are going to order your company to sell life insurance in L.A. so that we don't lose the benefit of the electoral vote for the next presidential election; are you going to be happy with that situation?

Mr. STERNBERG. I have never faced it before.

Mr. KANJORSKI. Well, there is no federal commissioner.

Mr. STERNBERG. But there are state commissioners, there are 50 state commissioners.

Mr. KANJORSKI. Yes, but you can pick up and leave the state of California and he can't tell you to do anything. You have got 49 other states to do business in. If you have got a national charter, he is going to say, "If you want to do business in those 18 states you like now, Mr. Sternberg, you are going to have to do it in California, too, and here are the terms and conditions you are going to have to do it under." Do you want that done to you?

Mr. STERNBERG. Would I like that? No. Would I abide by it? Sure. If everyone else in the industry has to abide by it also, then we would do it. I would just spread my risk further.

Mr. KANJORSKI. Well, I am just wondering, I am posing the question because I am hung up, quite frankly. I am a person who recognizes the distinct differences between regions and states in the country and the country as a whole. I sometimes make the comparison that going to Utah as an Easterner is like going to Austria. It is almost a different country in terms of the make-up of the people and the climate and everything else. And I think since I have gotten elected to Congress, I have gotten a great deal more respect for the differences that exist in the country as opposed to the sameness and the uniformity of the country. And I am just wondering, insurance seems to be a very personal thing to me. It is insuring property in a particular area. It is insuring my life or someone that is close to me. It is a very localized, very special community area. And I am wondering if we nationalize it whether we are going to lose something there or are we just going to further cause the big operators, the huge operators to dominate the field.

I sometimes wonder with H.R. 10 whether we haven't consolidated the financial services industry to the point where they no longer have to pay attention to the state of Iowa, who cares? There is another state out West that I think the largest bank is $100 million. Is it Iowa or another state? But, anyway, they are so insignificant that a lot of major companies don't even look at them. It is a flea on the back of an elephant. Maybe that is a good example too, considering what the elephant represents. But don't you fear that that may happen if we nationalize insurance?

Mr. STERNBERG. Actually, the exact opposite will happen, because, as I mentioned, there are states we won't go into because the populations are too small, whereas if we didn't have to face the extra regulation that those states now impose on us, we would be happy to be in those states. We would love it.

Mr. KANJORSKI. Mr. McOwen, I know you write workman's compensation insurance. And being an old workman's compensation administrative law judge, I never did understand the massive jurisdictions—I didn't even understand how you come up with premium rates, quite frankly. It just was so complicated as to safety standards, et cetera, that apply in the various states and the rates that apply, et cetera. But how would that work? Would there be an advantage or a disadvantage to the say, small states as compared to the large industrial states, if the premium and policy requirements were uniform?

An example, I think it is present now in Pennsylvania, the minimum workman's compensation is like $350 a week, something in that range. And yet in the state of Mississippi, I think it is $110 a week. So that if you get injured, they tell you to drop on a train and drop off in Pennsylvania if you are injured in Mississippi because you will make out a hell of a lot better. But isn't this a problem that if we uniformize it that we take away the state uniqueness? Even sometimes policies and costs like that being used as an economic advantage by states wanting to attract industry, they try and drive the price down or the benefits down?

Mr. MCOWEN. Well, I think that there are a couple of answers to that question. And one answer is to examine the way states deal with this issue. Now, part of state regulation is that insurance rates cannot be unfairly discriminatory or excessive. And that reflects the state regulator's interest in having a fair rate to the consumer. But it also reflects the regulator's interest in the solvency of the carrier. Rates are set by risk factors. And a large risk factor or a high risk factor engenders a higher rate. A low risk factor engenders a lower rate. And it is up to the insurance company to help the consumer find a way to mitigate his risk factors to earn a lower rate.

I would assume that a federal regulator would be as interested in solvency as a state regulator. So it would not seem likely to me that a federal regulator would impose a restriction or an edict that says you must charge the same rate in all states. Rather, I would say that the national regulator would be concerned for solvency and therefore would continue to look at rates being charged relative to risk factors, which generally are not geography. I mean even in one state you have parts of states where auto rates may be higher than others or different kinds of rates are higher or lower.

Mr. KANJORSKI. Well, as a Member of Congress, I would be very much tempted to make a uniform workman's compensation payment throughout the entire country instead of seeing different rates in different areas simply because I find it very difficult to understand how a person who has a total disability can live at the rate paid in Mississippi relative to what the rate is in New York or Pennsylvania. And wouldn't it be our temptation here to pass legislation saying there shall be relatively uniform rates paid in workman's compensation throughout the country? We are not setting the rate of the premium or what is going to be paid, we are just saying fairness. Or the large states get together and say, look, why are we paying so much more compared to these small states and they are stealing our industry. Let's get the Congress to pass a uniform rate, then that takes that away from competition.

Chairman BAKER. We can come back to this. Let me get Ms. Biggert in.

Mr. KANJORSKI. Oh, surely. Oh, I am sorry.

Chairman BAKER. Ms. Biggert?

Mrs. BIGGERT. Thank you, Mr. Chairman. This question is for Mr. Gilliam. You heard NAIC Commissioner Vaughan testify in the first panel about the new efforts of NAIC to achieve uniformity through interstate compacts and yet she also, when I asked her about CARFRA, that it didn't seem to be working so they virtually have abandoned that to go to the interstate compacts. And yet a year ago, when NAIC testified here, it was to be the answer to the product approval problem for life insurance and that I think it was said that in approximately a year from now we would have a working CARFRA mechanism that would allow all 51 jurisdictions to participate, plus the District of Columbia, and that doesn't seem to have happened, and that was abandoned. Aren't you a little bit skeptical about how this interstate compact will work?

Mr. GILLIAM. I don't think I can be skeptical yet. If you use— and, again, I mean no disrespect to the NAIC. In fact if Commissioner Vaughan felt like the Lone Ranger here this afternoon, I am her loyal sidekick, Tonto. But perhaps the CARFRA interstate compact example is an example of why if CARFRA ends up on the cutting room floor, why one idea is tried and if doesn't catch on, we move to something else. And I think that is a healthy thing, to look at new innovative ways to handle that situation.

Mrs. BIGGERT. Well, then how many years do you think it takes to judge whether a program is a success or a failure? And how many—in this world of competition, with the other financial institutions, how many products can be lost by the insurance industry waiting for something that will work as far as the regulation?

Mr. GILLIAM. Well, single point of filing and approval of products in one state and all states is certainly the Nirvana we are all looking for. And I can't look into my crystal ball and tell you that we give the states a year and a half, two years, three years, five years, ten years. We have to a lot faster than we did with Gramm-Leach-Bliley, but I guess my point is let's at least give some consideration to letting the states get this thing right before we turn it over to 1-800-Washington.

Mrs. BIGGERT. Okay, thank you.

Then, Mr. Sternberg, I would just like to thank you for your testimony. I think it very clearly put what is really happening in the industry and how the regulations are affecting you, I think very succinctly. And appreciate your testimony.

Mr. STERNBERG. Thank you.

Mrs. BIGGERT. And I would just like to ask one question, and that is how is the life insurance industry faring under the current regulatory structure? Are smaller companies disappearing?

Mr. STERNBERG. Yes, they are. There are 16 percent less today than there were five years ago. And there will be 10 or 15 percent less in another five years. And I think the whole industry has, in terms of the investment community, has a serious problem because we are not throwing off—and I am saying big and small, we are not throwing off the kind of profits that would command the investments that need to be made in every industry to keep up with the world.

Mrs. BIGGERT. Okay, thank you.

Thank you, Mr. Chairman.

Chairman BAKER. Thank you, Ms. Biggert.

Dr. Weldon?

Dr. WELDON. Thank you, Mr. Chairman. I just have one question for Mr. Gilliam. Prior to Hurricane Andrew, we had 1,200 property casualty companies in the state of Florida, and now I think we are down to less than 200. Some of the inflation in premiums that we have seen in the property and casualty sector obviously is attributable to the reasonable calculations of risk. But there are some people in our state who legitimately argue that a big component—or component of the price inflation has been a decline in competition, basically. And there are a lot of proposals being put forward to try to bring more carriers into the state.

One of the questions I get asked is this issue of a federal charter, it would make it easier for companies to come into the state, increase the number of companies, increase the amount of competition, and perhaps have an impact on premiums. How would you respond to that? You made some very persuasive arguments about this current system working well. How would you respond to that question?

Mr. GILLIAM. I think it would have just the opposite effect. I would hold out Florida as the national poster child for state regulation, because the issues that Florida faces with its high probability of risks for hurricanes and catastrophes is far different from what the risks are in Iowa or Nevada or other states. And if we have a national federal regulator who is overseeing everything, there is not going to be as much sensibility on his or her part as to the unique concerns in Florida.

Dr. WELDON. Well, let me clarify my question. I would never—at least I don't think I would ever want to preempt state regulation. I view this as sort of like the approach in banking where you have the option of state licensing or state chartering versus a federal charter. How would you respond? You were on a roll there, do you want to continue? You were starting to say you thought it would make things worse?

Mr. GILLIAM. Well, you bring up the general issue of disaster and catastrophe, and I failed to bring my trailer load full of data on that issue. That will be the subject of many more hearings before this committee. But having been very involved on the national scene on legislative issues dealing with catastrophes, I can't see how the creation of an optional federal charter is going to bring more competition to Florida in terms of insuring catastrophic risks. I wish I had some of my data with me, but I think in the last five years, while there may be a smaller number of companies selling P&C coverage in Florida, it is a much more competitive market. The prices are kind of leveling out. And I believe that your state mechanisms, the JUA and so on, have become vastly depopulated. And I just can't think of any advantages to an optional federal charter in terms of the problem with insuring catastrophic risks in Florida.

Dr. WELDON. Well, thank you very much. I appreciate your comments.

And I want to commend you, Mr. Chairman, for the panel that you put together. I think we have heard some very, very good testimony on this issue.

Chairman BAKER. Thank you, Doctor.

Mr. Kanjorski?

Mr. KANJORSKI. Yes, Mr. McOwen, I will go back to you on that workman's compensation, just to clear it up. Would we be in effect going into a national workman's compensation system if we have a federal charter? And how would that impact on the state legal systems that apply workman's compensation, the competitiveness of rates, the competitiveness of payments under the workman's compensation system, how would that work?

Mr. MCOWEN. Well, I think that there are a couple of issues there. Workers' compensation has two parts. One part is medical coverage. And the other part is lost wages. If you were to standardize the wage loss component, there would probably be an adjustment, a rate adjustment in terms of being able to support that wage loss component in the marketplace.

Ultimately, the cost of workers' comp reflects the experience of losses and the lost costs involved in determining the rates. And I don't think that under a federal system that would change. I think the insurance, it works because of spread of risk, and it would continue to work because of spread of risk. It works because of fair prices charged for the exposure. And, as I said earlier, higher exposures engender higher costs, lower exposures, a lower cost. So I think that that would continue to be true.

What I think that might help with the administration of workers' compensation is that a single charter, if a company wanted to have a federal charter, it would have fewer individual market conduct issues and regulatory issues to navigate in terms of the efficiency of its company. And a greater efficiency would then be reflected in the cost of its product and its ability to get new products to market and its ability therefore to serve the consumer. And I think therein is the advantage.

Mr. KANJORSKI. Very good. Thank you, Mr. Chairman.

Chairman BAKER. Thank you, Mr. Kanjorski.

Just to follow up a point, Mr. McOwen, with regard to the issue of a national charter and let's say, property and casualty in Florida. Your point you made a moment ago was that the industry works by spreading risk, so that if you have a loss in a particular area or line, that those losses as to the corporation will be offset by profits from other areas of activity. It would seem to me to be fairly advantageous, if I was in that marketplace, to have insurance in lovely Pennsylvania, Florida, as many places as I could get because the likelihood of repetitive loss spread across the broader market would be far less, thereby making capital adequacy a much more sure thing than if I was a single line person located on the coastline of Florida and that is the only place I sold. Is that logic flawed?

Mr. MCOWEN. No, I think that logic is accurate. I am not sure that a federal charter is necessarily the answer to market availability in a state with a catastrophe exposure. I think an optional federal charter is intended to answer other questions than market availability. However, you are correct, spread of risk is certainly what makes insurance work. And the ability to write the same kinds of exposures in multiple states is an advantage for a company. Unfortunately, we cannot write hurricane exposure insurance, for instance, in 50 states. There are only a few states that have a hurricane exposure. And, again, I don't think an optional federal charter is intended to enhance market availability or to answer those problems of catastrophe issues.

Chairman BAKER. Sure, no. But my point, contrary to that of Mr. Kanjorski, subsidization of some other consumer of the same company located in a different jurisdiction, that occurs because capital is fungible. Where you have losses, you use those resources to pay off the losses. And you hope by having the risk spread in broad enough jurisdictions, you make enough money on the whole to be able to remain solvent. So my only point was that broader geographic exposure, at least in that marketplace, makes some sense.

Mr. Kanjorski?

Mr. KANJORSKI. Well, the only point—you are absolutely right, but when you carry that to its logical conclusion, the people in Pennsylvania would be paying a higher insurance rate because of the losses of Mr. McOwen's company in Florida.

Chairman BAKER. Correct.

Mr. KANJORSKI. So you would be accomplishing, outside of the federal system of catastrophic insurance but you would be saying because you have a national charter, you folks in Pennsylvania on the high mountains that never get flooded, never get a hurricane, your premium is going to go up because we have losses in Florida. And that may be the disadvantage of having the federal charter, because right now the insurance concentrates, particularly in the smaller companies, so that it gives the area that doesn't have that catastrophic potential or the potential loss, they don't pay a premium for that. And that is where capital will flow.

Let me give you the example. If you had a client that wanted to build a $100 million building, and you have the choice of Kokomo, Indiana or Miami Beach, Florida. Naturally, there wouldn't be much rocket science to think that if it goes to Miami Beach, Florida, appreciation is going to be much better on his asset. But the thing in the insurance business, that if you honestly assess premiums for risk, his premium against hurricane loss in Florida is probably going to put his rate two or three times what it would be in Kokomo, Indiana. Therefore, he would look at Kokomo, Indiana as a potential investment because of the high risk. If you uniformize that risk, you are going against social policy and encouraging capital to flow to the highest risk areas, because the under-risk areas are going to pick up the premium for it.

Mr. MCOWEN. Well, could I add a comment to that?

Chairman BAKER. Certainly, jump in.

Mr. MCOWEN. If you look at the federal flood model—

Mr. KANJORSKI. Well, that is subsidized.

Mr. MCOWEN. Well, but the point I was going to make is that flood insurance is required for homeowners who live in areas where there is a likely flood. We don't require all homeowners in all states to buy flood insurance to spread the risk. But we do require all homeowners who live in a flood area to buy flood insurance.

Mr. KANJORSKI. Yes, but it is so subsidized.

Mr. MCOWEN. It is subsidized, but the price reflects the fact that there is exposure to flood in those areas. I am just addressing the fact that—

Mr. KANJORSKI. No, no, but by virtue of the fact that it is subsidized, we are spreading the risk to the entire country. The taxpayers are picking it up on an equal basis. That is a tremendous spread of the risk, but we do it through governmental activity. That is exactly what we probably do not want to do, to give an area that has a great disadvantage an equality with other areas, because we are going to require either the private marketplace to pick it up by virtue of the federal charter or subsidization by using taxpayers' money—the country as a whole, to pick up that loss.

The very nice thing about insurance now is that it stays very close to the supply and demand of the marketplace.

Mr. MCOWEN. Right.

Mr. KANJORSKI. It is a real market force once the conditions are worked out and rates are worked out. But we are talking about disturbing that when we are talking about spreading the rates uniformly by either action of the Congress or action of the federal commissioner or by subsidization. That changes the marketplace.

And I think I hear from most of the insurance industry that they really like their free enterprise system and supply and demand and really don't like all of us to stick our hands in their brew, if you will. And we have been doing it in several ways like subsidization. But at least that is an honest—we say it is so important, federal taxpayers are going to subsidize terrorist insurance, we are talking about subsidizing. No question about it. But here now we are talking about indirectly, through charter mechanism and federal control, the ability to subsidize to the entire country base without putting that up to a vote or without having the investor or the insured have any say in the matter.

Chairman BAKER. But I think that happens today, Paul, to some extent where you have a large corporation that is licensed to do business in 50 states, who has capital available. The regulator looks at the capital adequacy of the parent company. And the company sets its rate based on, let's say, competitive factors, the fact that it can have a loss leader and offer a product at a lower price, it captures significant parts of the market. Then go back to the regulator and allege now because of market conditions, people going out of a business, you have a higher likelihood of loss, you are going to raise your premium.

So I think it happens indirectly today. You are correct, I think it makes it more pronounced.

Mr. KANJORSKI. No, but today State Farm was able to get out of Florida. They just said we won't write casualty loss insurance in Florida, because it is a loss. Under our system, they are not going to be allowed to get out of Florida. We are going to say you are licensed nationally. Florida has a problem because of its hurricanes. But you are going to write insurance in Florida and pass it off to the other 49 state participants or you are not going to have your federal charter. And you know, the Congress would ultimately do that.

And when I look at the three major states here that are giving us problems—I didn't catch the fourth—but New York, California, and Florida are the least cooperative, apparently, in getting this uniform system on a state basis, compact basis, started, I begin to wonder just why they do that. And they are the three states for catastrophic insurance and have taken advantage of catastrophic insurance. They are the three states that perhaps a what, about 20 percent of the American population and maybe about 40 percent or 50 percent of the economic activity of the country.

Chairman BAKER. Now, I think that may go to economic issues, wanting to maintain control of significant parts of the market without the enhanced competition that would be brought about if you didn't have the barriers. But—

Mr. KANJORSKI. Mr. Chairman, I know that we could go for—

Chairman BAKER. Yes, we probably will.

Mr. KANJORSKI. I just want to thank you. I think these have been great hearings. The first panel and this panel have been very informative. I can't think of too many hearings that I have been this interested in, quite frankly, since I have been in Congress.

Chairman BAKER. And that is saying something, because this is the third of these hearings that have gone four and five hours. And we have actually been interested in the topic. So you all have done a marvelous job. Thank you very much. I do express our appreciation. Should you have additional comments, the record will remain open for 30 days, as all members may have additional time to file any amended statements they wish to file for the committee's purposes.

With that, I thank you, and our meeting stands adjourned.

[Whereupon, at 5:00 p.m., the subcommittee was adjourned.]

A P P E N D I X

June 4, 2002

Opening Statement

Chairman Michael G. Oxley

Committee on Financial Services

Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises

"Insurance Regulation and Competition for the 21st Century"
June 4, 2002

Insurance is one of the oldest and most important global infrastructure industries, originating over 5,000 years ago with the ancient Babylonians, Phoenicians, and Greeks. Global premiums now exceed over $2.5 trillion, with almost a third of that amount originating from the United States. The U.S. insurance industry is also a major source of jobs for U.S. citizens, employing 2.3 million people in 2000. In fact, over the last 10 years, employment in the insurance industry has averaged about 2% of the total U.S. population.

Yet railing against the insurance industry has always been a favorite pastime of politicians, with many believing that insurers are largely unregulated with enormous profits. Nothing could be further from the truth. In fact, insurers are heavily regulated by 56 different States and territories with overlapping jurisdictions each trying to impose their laws extraterritorially in an often conflicting manner.

This regulatory inefficiency has caused great weakness in the financial stability of insurers. In the property casualty industry, insurance underwriters have suffered both a statutory and net underwriting loss every year since 1979. Almost every year, property casualty insurers have been paying more in claims and expenses then they have taken in from premiums. In the last year available, property casualty insurers had an annual rate of return on equity of approximately 6%, compared to 10% for life insurers, 15% for Fortune 500 companies, and 21% return for diversified financial firms.

These negative financial results are ultimately borne by consumers through higher prices and less coverage availability. As insurers are unable to derive a sufficient rate of return, they are forced out of markets and put at greater solvency risk, placing consumers at risk of losing their coverage and forcing an industry consolidation and loss of competition. No industry can be artificially impaired for so long and continue to function effectively to protect consumers. The health of our insurance infrastructure is critical for our economic growth and safety.

One of our previous witnesses testified, "insurers destroy shareholder value." But it is not insurers who are the problem – in fact, our American insurers have been leading the way in the global insurance markets. It is the weaknesses in the current regulatory structure for some states that destroy shareholder value. Some states have done an excellent job governing insurance markets and promoting uniformity. However, the price fixing and heavy anti-consumer regulations in other states have led to a balkanized system that can be inefficient, denies consumers choice, and is destroying the industries' competitive ability to raise capital. The need for reform is no longer a question but an imperative.

Last year the Committee began a very close examination of the current structure of insurance regulation to better understand the system and to determine the need for reforms. In May we held a hearing on NARAB to further nationwide uniformity for agent licensing. We also reviewed the approval process for new insurance products with a hearing on speed to market issues in June 2001. In August, we continued the Committee's review of insurance regulation and held a hearing on the over-regulation of automobile insurance denying consumers choice and competition. We had planned additional hearings for later in the year, but it was necessary to put the Committee's agenda on hold following the events of September 11, to focus on passage of the PATRIOT Act and the Terrorism Risk Protection Act.

Today's hearing begins a transition in the Committee's examination of insurance regulation as we turn from assessing the current inefficiencies to a review of the various proposals for reform. Consensus will be difficult, but America deserves our every effort to keep our insurance infrastructure the strongest and most competitive in the world.

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June 4, 2002

Opening Statement for Congressman Paul E. Gillmor
House Financial Services Committee Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises Hearing
"Insurance Regulation and Competition for the 21st Century" Day 1

I would like to thank Chairman Baker for holding this important hearing this afternoon, the first in a series of discussions on how best to reform and modernize our current insurance regulatory system.

Several reform proposals have already come to the committee's attention and I look forward to hearing today's witnesses' opinions in this regard. Before this committee considers any substantive legislation in this area, lengthy discussions must take place considering all the ramifications of changes such as optional federal chartering, interstate compacts, and federally targeted uniformity proposals.

As a member of the House Energy and Commerce Committee during the consideration of the Gramm-Leach-Bliley Act (GLBA), I remember the intense debate surrounding federal regulation of the insurance industry. As in other areas addressed in the GLBA, it is important that we review the implementation of the agent licensing standards, and assess the changes in the industry as a result, before considering additional new regulations.

It is widely agreed that the time for modernization of insurance regulations has come and I commend our subcommittee chairman for realizing the importance of this issue. I hope today's discussion and those to come will lead us toward a reform proposal that addresses the concerns of those most supportive of optional federal chartering while continuing to improve state regulations.

Again, I would like to thank the chairman for holding today's hearing and our witnesses for joining us. I look forward to a healthy exchange of ideas.

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Opening Statement
Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises
Committee on Financial Services
Hearing on Insurance Regulation and Competition for the 21st Century
June 4, 2002

Mister Chairman, thank you for calling this hearing. As you know, I am new to the House and so a series of hearings like this are very handy.

We are meeting today to discuss modernizing insurance regulation. There is no secret that the big issue here is whether there should be an optional federal charter. I know that many of my colleagues have confronted that issue for many years now. I look forward to these hearings so that I can continue to develop some thoughts on this important issue.

Mr. Chairman, I know that you are a strong protector of states' rights. And I know that you agree with me that the states are the incubator for some great ideas. Some things need to be regulated on the state level, so that our communities can address local concerns creatively. As different states try different approaches, best practices are moved from state to state and a regulatory consensus develops. This doesn't happen on every issue. Indeed, as my colleague, Mr. Ross, will tell you, the needs of Arkansas are very different from those of New York. So some differences continue to exist.

However, companies dealing in insurance face a very daunting prospect: 50 separate regulatory regimes around the country. After the 1944 Supreme Court decision that declared insurance to be interstate commerce --and thus subject to federal oversight-- Congress spoke out and passed the law that would be the basis for federal insurance policy for over 50 years: the McCarran-Ferguson Act of 1945. This law declared Congress' view that state insurance regulation was in the public interest. Since then we do very little at the federal level on insurance. But the world has changed a great deal in 50 years, especially in the financial services world.

This Committee is right to ask the question of whether or not there should be a federal charter. We may decide that there absolutely should be. We may not. There is a great deal to be learned in these hearings, and I look forward to completing them today and over the next two weeks.

OPENING STATEMENT OF
RANKING DEMOCRATIC MEMBER PAUL E. KANJORSKI

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES

FIRST HEARING ON INSURANCE REGULATION AND COMPETITION FOR THE TWENTY-FIRST CENTURY

TUESDAY, JUNE 4, 2002

Mr. Chairman, today we meet for the first time this year to discuss the insurance industry and the challenges that it faces. I commend you for your diligence in convening this series of hearings. Your efforts to educate the Members of our Committee about insurance regulation will potentially serve as the basis for future legislative action in this arena. I suspect, however, that it will take us at least several years to forge a consensus on this complicated set of issues.

The American insurance industry, as you know, is broad and diverse. According to one estimate, we have approximately 5,763 insurance companies operating in the United States. These companies vary greatly in size, structure, and product offerings. For the last 150 years, the states have traditionally regulated these insurers.

Nevertheless, a discussion of insurance regulatory reform -- including various proposals designed to increase the efficiency, promote uniformity of insurance regulation, or create an optional federal charter -- flows naturally from our actions in the 1999 law to modernize the financial services industry. That statute removed the obstacles that prevented banks, securities firms, and insurers from affiliating and competing with each other. It also provided for the regulation of financial products by function, rather than by institution. Additionally, that law reaffirmed the McCarran-Ferguson Act of 1945, which calls for the regulation of insurance at the state level.

The 1999 reform law has also begun to change marketplace dynamics. In fact, a number of insurers have reported that they increasingly find themselves in direct competition with brokerage firms, mutual funds, and commercial banks, all of which may have a competitive advantage due to their arguably more efficient federally based regulatory systems. For example, in many instances a bank may introduce a new product immediately without any action by their regulator, and securities firms can typically bring new products to market within 90 days. Insurers, however, sometimes have to wait more than a year to secure all the required approvals to offer a new product nationwide.

As a result of these and other changes, some now contend that the current regulatory system for the insurance industry has become too cumbersome and requires reform. For example, a recent study by the American Council of Life Insurers concludes that the lack of uniformity in state laws, the burden of dealing with numerous jurisdictions, and the excessive time required for new product approval are of paramount concern to insurers who want to compete nationally. In response to these mounting criticisms of state insurance supervision and the growing recognition that market forces have changed the financial services industry, the states have initiated their own efforts to modernize insurance regulation, primarily through the National Association of Insurance Commissioners.

This debate over how to reform insurance regulation has also seeped into Congress. Earlier this year, our colleague, Congressman John LaFalce, introduced H.R. 3766, the Insurance Industry

Modernization and Consumer Protection Act. His bill would allow insurers to obtain an optional federal charter and afford consumers with various protections. As we begin our series of hearings, I want to commend my Ranking Member for his leadership on this important issue.

From my perspective, the most important thing that we can do in the short term to help the insurance industry is to pass legislation to provide a terrorism reinsurance federal backstop until the private sector can address the problem. In the long term, we should also explore how to modify insurance regulation and whether we should create an optional federal charter. One idea that merits our consideration is whether we should create a tiered regulatory structure for the insurance industry as we have already done for investment advisers. The federal government would regulate insurers above a certain size or in certain business lines while states would retain the responsibility for regulating the rest. During these debates, we should also carefully examine consumer protection issues. In the end, consumers should be the ultimate beneficiaries of our actions.

In closing, Mr. Chairman, I believe it important that we learn more about the views of the parties testifying before us today. Their comments will help us to better understand the different approaches to reforming insurance regulation and the key challenges the industry faces. I also look forward to working with you over the coming weeks and months as we proceed with additional hearings to examine today's evolving insurance marketplace and the need for regulatory reform.

Opening Statement
Congressman Ed Royce (CA-39)
4 June 2002
Insurance Regulation and Competition for the 21st Century

Thank you, Chairman Baker, for the opportunity to share my views with the subcommittee here today on the topic of insurance regulation and competition. I would like to commend the Chairman for bringing the important topic of insurance regulation in the 21st century to light through this hearing, and I look forward to engaging in an in-depth and ongoing dialogue with my colleagues -- with the benefit of insight and testimony from the insurance industry -- to ensure that Congress pursues a path that will help the insurance industry to operate as fairly, competitively and efficiently as possible.

The insurance industry has a long and distinguished history in the United States. However, in recent years, the costs of complying with the inconsistent legal and regulatory requirements created by a patchwork of individual state regimes have made this valuable and necessarily consumer-responsive industry far less competitive and consumer-friendly than it should be.

I am interested in hearing our witnesses' thoughts today on what steps Congress could take to improve the current system while allowing the principles of the free market to work. Although there seems to be a consensus within the industry that something needs to be done to improve the operating conditions of the insurance industry, I strongly believe that if and when true federal reform comes to fruition, it will only be accomplished with increased accountability and competition, not by simply adding another layer of federal regulation to an already cumbersome process.

Of course, the possibility of creating an optional federal charter for insurance is not the only issue that needs to be addressed here today. As Steve Harter, the President of the National Association of Professional Insurance Agents, mentions in his testimony, there are many other issues in need of reform. Issues such as foreign corporation filings and background checks are concerns that need to be addressed at some level, and I hope that any other issues that our witnesses feel need to be brought to the attention of Congress will be aired in their testimony or through their responses today.

I thank the Chairman for his time, and for his leadership in bringing this issue to the attention of this subcommittee. I would like to take this opportunity to thank our witnesses for taking the time to share their insights on the topic of federal involvement in insurance regulation and competition. Finally, I look forward to working with my colleagues to reach the best and least intrusive solution for the insurance industry and the American consumer.

Testimony of
Steve Bartlett, CEO
The Financial Services Roundtable
before
House Subcommittee on Capital Markets, Insurance and GSEs

June 4, 2002

INTRODUCTION

Mr. Chairman and members of the Subcommittee, The Financial Services Roundtable greatly appreciates the opportunity to testify this morning regarding modernization of insurance regulation. We commend the Subcommittee for addressing a significant problem facing our financial system and the economy.

The Financial Services Roundtable represents 100 of the largest integrated financial services companies providing banking, insurance, and investment products and services to the American consumer. Member companies participate through the Chief Executive Officer and other senior executives nominated by the CEO.

Roundtable member companies provide fuel for America's economic engine accounting directly for $1.7 trillion in owned assets, $12.4 trillion in managed assets, and $561 billion in revenue, and 1.8 million jobs.

The Roundtable believes that Congress should act expeditiously to assure that the American economy is well served by an insurance industry that is modern, competitive, healthy and responsive to the needs of American consumers.* Unfortunately, our current system of insurance regulation and supervision does not and cannot permit the insurance industry to be fully responsive to the needs of the economy or the consumers of its services. Consumers (be they individuals, small businesses, or Fortune 500 companies), and the insurance companies that serve them, need and deserve regulatory modernization now. A significant part of this reform must be an optional federal charter for insurers.

* Attached is the Statement of Policy adopted by the Board of Directors of the Roundtable formally reiterating its support for an optional federal charter.

We believe the Roundtable is uniquely positioned to assist the Subcommittee as it examines the concept of a federal charter in the context of the overall modernization of insurance regulation. The Roundtable's membership includes all elements of the financial services industry – an industry that is national and global in scope. Collectively, our members are regulated and supervised by every significant financial regulator – state or federal – in this country, and many abroad. Indeed, we are the only trade association whose membership includes both traditional insurance organizations, which are regulated under the state insurance system, as well as banking organizations, which have had the choice of federal or state charter/supervision for over 135 years.

In inviting the Roundtable to testify, you have asked us for an overview of the economic and marketplace challenges facing the insurance industry in light of the current state system of regulation, and the costs of that regulation to customers.

Our testimony will:

- highlight some of the marketplace challenges confronting the industry;
- identify the consequences of the current system;
- outline the principles that the Roundtable believes should be applied in reforming and modernizing the insurance regulatory system;
- identify four points which we hope will remain central to your coming deliberations on this important subject.

First, as these hearings will reflect, there is no real disagreement about the need for significant reform and modernization. Every witness you will hear from during these hearings will agree that there is a problem with the current system.

Second, and perhaps most important, the optional federal charter and legislation aimed at improving state regulation are complementary rather than mutually exclusive. They can and should be combined in a single integrated piece of comprehensive legislation.

Third, modernization of insurance regulation is about the economy and our customers and should not be a battle over regulatory turf or the interests of the industry.

And *finally,* we can ill afford to await a crisis to prompt comprehensive reform of this system.

MARKETPLACE CHALLENGES

The direct and indirect costs to national companies of dealing with the inconsistent laws and regulatory requirements of 55[1] different regimes are enormous. These costs are borne by customers and reflected in industry profitability. It is profitability, after all, that allows our companies to offer products and services at the lowest possible cost to the consumer.

One Roundtable member company involved primarily in the life business held inter-company discussions to identify estimated savings based on regulation under a federal charter. The assumptions were that the federal charter would allow for – and regulate – business in all states. The critical areas addressed were product regulation, producer licensing, and market conduct.

Duplicate costs identified were primarily materials, licenses and fees, technology costs, and personnel services. The burden of the state regulatory system on this company's cost structure extended to virtually all operating divisions including the corporate division. Based on an analysis of 2002 costs, savings for this Roundtable member company were estimated to total $21 to $25 million annually.

These figures, extrapolated across the breadth of the industry, are illustrative of the savings companies could afford consumers if insurance regulation were modernized. But that is just the experience of one company.

A look at the broader industry is also telling.

In 2000, the property/casualty rate of return (ROR) was 5.8 % and the life ROR was 10%. By contrast the ROR for commercial banks was 16.7%,[2] while the ROR for diversified financial services companies[3] was 21.3%. The 2000 ROR for the Fortune 500 overall was 14.6%. Indeed, according to the Insurance Services Office, Inc., during the period from 1984 to 2000, the return on net worth for the Fortune 500[4] exceeded the return on net worth for both large insurers and the property/casualty insurance industry as a whole for sixteen out of eighteen years.

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[1] 50 states, the District of Columbia, and U.S. territories.

[2] Source: Insurance Information Institute Fact Book, 2002

[3] Companies whose major source of revenue comes from providing diversified financial services. These companies are not specifically chartered as insurance companies, banks or savings institutions, or brokerage or securities companies, but they earn revenue from these sources.

[4] Fortune 500 Combined Industrial and Service Businesses median return on equity.

The myth that insurance companies are wildly successful and overcapitalized is precisely that: a myth. Since its peak in 1999, the capital of the U.S. nonlife industry has declined by $58 billion, or 17%. The trade combined ratio (TCR), the ratio of an insurance company's losses and expenses as to its premiums is an instructive way to view profitability. Since 1970, the property/casualty industry as a whole has had a TCR ratio of under 1:1 just five times. In 2000, the TCR was 116. This means that companies are paying out $1.16 for every $1.00[5] they earn in premium.

According to an article published by BestWire on May 23, 2002, the terrorist attacks, ongoing adverse revenue development, and increased asbestos and environmental payouts combined to make the 4th quarter and the full year of 2001 to the worst ever for the property/casualty sector.[6]

Clearly, under the current system insurance companies are not as healthy as others in the financial services sector. In fact, it is reasonable to assume that under the current state-based system, diversified financial services companies will continue to steer away from the insurance as a core business. The true cost of state-based regulation is manifest in the resulting lack of competition and choice for consumers.

But I do not want to leave you with the idea that profitability is all that has suffered. Companies cannot indefinitely pay out much more in costs and losses than they receive in premium while continuing to serve their customers properly. Consumers ultimately bear the cost in reduced choice and convenience.

This brief discussion is only suggestive of the varied market forces putting downward pressure on insurers including a slumping stock market and new risks associated with terrorist activities. We will continue to work with the Subcommittee to assist in its understanding the financial and economic forces at work in the insurance marketplace.

REGULATORY CONSEQUENCES

If the economic pressures on the insurance industry were solely the result of competition in a free marketplace, the public policy issues facing this subcommittee would be vastly different than they are. But the fact is that the existing regulatory structure adds a tremendous cost burden on insurers and at the same time stifles competition. Both the insurance industry and its customers have paid a significant price as a consequence of the

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[5] The Information Insurance Institute.

[6] A.M. Best Report: P/C Industry's 2001 Was Worst Ever. BestWire News Service, May 23, 2002

failure to deal with issues. Congress reaffirmed the primacy of state regulation when it passed the McCarran-Ferguson Act in 1945, but this country, its economy, and the delivery of services, have undergone a dramatic transformation over the past 57 years. We need to modernize our insurance regulatory system to eliminate unnecessary and duplicative regulatory costs and to permit insurance customers – individual consumers and businesses alike – to benefit from the innovation and efficiencies that only a free market can assure.

- Speed to Market: The need to get individual state approvals for products mean not only long delays in bringing products to market – in some jurisdictions, this can take years – but also huge costs associated with the time, complexity and duplication due to the differing requirements and standards of 55 jurisdictions. And there is a hidden cost to the current system; namely, some products never reach the market – a cost to customers that is impossible to quantify and impossible to deny.

The National Association of Insurance Commissioners (NAIC) has invested enormous time and effort in seeking to reform the system of bringing products to market. We applaud its efforts. But in the end, the NAIC can only propose important and useful changes. To be effective throughout the country, each of the 55 state legislatures and jurisdictions has to adopt these recommendations. That has proven to be impossible to achieve over and over again.

- Decreased Competition: Elimination of prior approval of products and rates in favor of a market-based regulatory framework would make product design and product pricing more competitive to the benefit of consumers. Market-based product design and pricing has led to lower costs and a richer product mix for consumers in virtually every other industry, including the various segments of the financial services industry. We see the benefits of competition every day in the innovation and price competition in the banking sector and in the insurance sector where states like Illinois have provided regulatory relief to insurers. We believe that consumers of insurance products will benefit in the same way.

The current state regulatory structure does not allow consumers to take full advantage of the technological innovations that are driving down the costs of other products and services. This will continue so long as national companies are required to comply with 55 regulatory schemes.

There are other models that provide a similar story. What we see in countries where rates and policy forms are less regulated is that when a company comes up with an innovative idea, others race to get similar products to market which ultimately drives down costs for consumers. Of course, those products that don't meet consumer expectations fail regardless of price. The important point is that the marketplace makes the decision.

- Lack of Uniformity: Unlike 57 years ago, the United States is a single national market for all financial services including insurance. As in every other industry, insurance companies that operate on a national basis should be able to choose one-stop regulation that is free of duplication, redundancy, and inconsistent requirements and interpretations. Based on our members' experiences in the banking sector, we believe that the ability to offer uniform products nationwide under uniform regulation will lower costs and benefit consumers. Also, it will eliminate the customer confusion that results when individuals and businesses move, only to find out that their insurance is far less portable.

- The Resources to Deal with Crises and the Lack of Expertise in Washington: Discussion in Congress in the aftermath of 9/11 has only served to dramatize what is painfully evident: strong federal expertise and oversight with respect to insurance is a critical and missing component in the support and maintenance of a healthy and resilient national economy. One can only imagine the chaos that could have ensued if the terrorist activities of 9/11 had eclipsed the ability of insurers to pay. We want to commend this Subcommittee – and you Mr. Chairman – for your leadership in promoting a temporary federal backstop to allow companies to get back into the business of writing terrorism risks.

PRINCIPLES FOR REFORM

The Roundtable has consciously determined **not** to craft its own proposal to address these concerns. Our decision reflects the fact that our membership has participated in the excellent work of our sister associations. Because we do not have a specific proposal to put forward, the Roundtable is able to work with the Congress and the Administration to pick and choose among the best ideas that are presented. Instead of specific legislative language, The Roundtable Board of Directors has embraced a set of principles that will guide our participation in this debate.

The Roundtable Board of Directors is confident that overwhelming benefits will flow from a modern framework of insurance regulation incorporating a properly conceived and constructed optional federal charter that reflects the following principles:

First, any federal system must be consistent with effective, high-quality state insurance regulation. We know from our bank members' experience that an optional system of federal regulation is completely consistent with a strong and viable system of state regulation. And we know that such a system produces strong players under both charters. For example, J.P. Morgan Chase – a Roundtable member and the 9th largest financial services company in the world – is a state-chartered institution[7]. The state system must remain strong and attractive. We believe, for example, special care must be taken to preserve tax neutrality between state charters and the optional federal charter.

Second, any framework of federal regulation must be truly optional. Insurance providers must have a genuine choice. Experience in the banking arena demonstrates that the competition provided by choice leads not to a "race to the bottom" or "competition in laxity" but a regulatory environment which is at once more effective and more innovative. The benefits that the banking industry and its customers have enjoyed as a consequence of the banking system should be available to insurance firms and their customers.

Third, a federal charter should be designed to permit insurance companies of all sizes and types to engage in multi-state operations in a seamless and effective manner. The marketplace for financial services is no longer restricted by geography – either within this country or beyond its borders. A national charter would recognize that fact and will maximize uniformity, efficiency and innovation. Such a framework will benefit both the industry and consumers.

Fourth, a new federal framework must represent the best in regulation emphasizing modernization and simplification. The federal framework must embody the best practices of state insurance regulation and innovative approaches to regulation from outside the insurance industry. We should not be satisfied with replicating the existing state system of insurance regulation at the federal level – especially pre-approval of rates and forms. Instead, reform should create insurance regulation designed for the 21st century and employ the best current tools and insights. The central tenets of such regulation must be to ensure solvency, protect customers, and allow the free competitive market to determine pricing and products.

Fifth, the system should be comprehensive. A federal option must be appropriate for, and fair to the entire insurance industry. A comprehensive system should grant federal courts jurisdiction over disputes involving nationally chartered companies. Further, the new federal framework should provide a meaningful choice for any insurance organization, regardless of corporate organization and line of business: mutual, reciprocal and stock; retail and wholesale; large and small; or life, property and casualty.

Sixth, the new federal regulator must have the stature and resources appropriate to the task. Establishing the new federal regulator as a new bureau of the Treasury Department would advance this goal, both in terms of prestige and the ability to attract qualified

[7] The Financial Service Fact Book: 2002. Page 28 (firms ranked by revenue).

leadership and staff. The Treasury is a department which has a long tradition of excellence as well as integrity in respecting the autonomy and expertise of its agencies.

If these principles are adhered to, we believe the following benefits will accrue.

- Customers, large and small, individual and corporate, will benefit from competition and choice. Insurers operating under a national charter and a single regulator will be able to serve their customers uniformly and efficiently in all parts of the country. National providers will be better positioned to use electronic commerce.

- An optional federal system of insurance chartering and regulation will bring national standards and practices to insurance regulation, while retaining all the benefits and innovations arising at the state level. Indeed, we believe an optional federal charter is entirely consistent with preserving states' rights and states' regulatory framework. As markets and companies evolve and innovate, a federal agency will be well positioned to develop sophisticated, uniform tools and standards for assessing risk and solvency, as well as appropriate consumer safeguards. As the largest companies become more complex – a virtual certainty under GLBA, a federal regulator will have the resources needed to examine and supervise them effectively.

- A federal framework can bring modernization and simplification to the insurance regulatory system. It should embody the best practices of state insurance regulation and innovative approaches to regulation from outside the insurance industry. A new national charter provides the opportunity to create insurance regulation that is designed for the 21st century and that employs the best current tools and insights.

- Elimination of prior approval of products and rates in favor of a market-based regulatory framework would make product design and product pricing more competitive to the benefit of consumers. Market-based product design and pricing has lead to lower costs and a richer product mix for consumers in virtually every other industry. We believe that consumers of insurance products will benefit in the same way.

- American insurers expanding internationally will benefit from a highly credible home insurance regulator in their home country. A federal agency will naturally be regarded as a peer by regulators in every other country. A federal agency will be a strong and coherent voice in the international arena promoting open markets, competition and transparency in regulation.

- Regulatory costs associated with the current duplicative requirements and time-consuming multi-state reviews would be reduced for companies subject to a single regulator. One estimate is that there could be a $300 million savings alone from direct regulatory costs for life insurers from elimination of duplicative exams and licensing fees, and these costs are but a drop in the bucket compared with the costs associated with duplication, delay and inconsistent and conflicting requirements. The elimination of these costs would both enhance soundness and confer significant consumer benefits.

Of course, these benefits will occur only if the new federal framework is well conceived, properly constructed and appropriately staffed.

PROCESS FOR REFORM

We should recognize that there may be spirited debate about specific aspects of the solutions, but there is no debate that the current system requires modernization and reform. The efforts of the NAIC to this end speak for themselves. The question before the Subcommittee is no longer whether but how.

An optional federal charter and framework of insurance regulation is essential to the health and vitality of the American insurance industry. The Roundtable believes that it is equally important that the state system of insurance regulation be strong and vital. We strongly support State efforts, led by the NAIC, to improve the system of state regulation. Our insurance members have actively participated in NAIC working groups to this end. We also support congressional action, where possible and appropriate, to enhance the effectiveness of the NAIC's hard work. And, we are encouraged by the NAIC's efforts to develop state compacts.

Similarly, we are supportive of the thrust of proposals developed by the Independent Insurance Agents and Brokers of America to develop federal legislation that will enhance the workability of the state system. In the last decade, Congress has amended the federal banking laws to ensure the continuing competitive strength and vitality of state banks and state bank regulation, and we are confident that the same can occur with respect to insurance regulation.

At the same time, and this may be the most important thing that I say today: NAIC efforts or others' proposals for uniform national standards are **NOT** alternatives to an optional federal charter. Rather, they are complementary and, properly crafted, perfectly compatible with optional federal charter legislation. The Roundtable urges you to not choose between federal legislation that improves the state system and legislation that provides for an optional federal charter.

For similar reasons, we urge you not to be seduced by the notion that incremental change – starting with legislation to enhance the state system while delaying a federal charter option – is sensible. While we recognize the possible political appeal of an incremental approach, the right thing to do, is to combine optional federal charter legislation with legislation designed to facilitate modernization and reform of the state system into a single comprehensive proposal.

You will undoubtedly hear a great deal from others about the problems that the current system poses for the insurance industry. These concerns are genuine and valid. At the same time, the focus should be on the degree to which the American consumer suffers as a consequence of the current system. The debate must focus on the design of a regulatory system that is appropriate for a national marketplace and that reflects the best practices in the financial services industry.

CONCLUSION

We believe that it is critical that we put in place a framework of federal oversight of insurance immediately. The need for such a system was evident at least two decades ago. The industry and the American public have paid a huge price because neither industry leaders nor we in Washington were willing to grapple with the admittedly difficult substantive and political issues such a step poses. These hearings and your further deliberations lay a firm foundation for action early in the next Congress, if not before.

The Roundtable thanks you for holding this timely hearing and for your commitment to a competitive marketplace. We look forward to working with the Subcommittee in the coming months. I would be pleased to answer questions.

PROFESSIONAL
INSURANCE
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Testimony of Steve Harter
President, National Association of Professional Insurance Agents
before the House Financial Services Subcommittee on
Capital Markets, Insurance, and Government Sponsored Enterprise
June 4, 2002
2129 Rayburn House Office Building

HARTER: Thank you, Mr. Chairman and members of the Committee.

My name is Steve Harter. I am an independent insurance agent and I own my own insurance agency, Select Risk Management, in Ava, Missouri.

This year, I have the honor of serving as president of the National Association of Professional Insurance Agents. Founded in 1931, PIA is a national trade association that represents member insurance agents and their employees who sell and service all kinds of insurance, but specialize in coverage of automobiles, homes and businesses.

On behalf of PIA and its members, I would like to thank you for this opportunity to testify before the committee.

Profile of the PIA Member Agency:
Like me, PIA National members are the owner/principals of their independent insurance agencies. They employ an average of seven to nine full-time individuals including themselves, who are licensed as insurance producers. Additionally, they employ two to four individuals who are not licensed producers. Our members represent an average of between five and seven property and casualty carriers and two to three life and health carriers.

PIA agencies provide their individual clients with personal lines insurance (such as homeowners and auto). In addition, they provide small-to-mid-sized commercial business clients with property and casualty, as well as life and health individual and groups products.

Over 40% of our member agencies write farm business and are agents in the Federal Crop Insurance Program (FCIP) through their private sector carriers. Seventy percent of PIA members also write federal flood insurance through their private sector carriers. Also, because of their expanding engagement in the life business, 40% of PIA member agencies employ individuals that are licensed securities producers.

On a regular basis 10-25% of PIA members' books of business require placement in the non-admitted specialty market. This means that in the regular course of their business, PIA member agencies conduct both agent and brokering activities for commercial lines in the property and casualty business.

PIA members actively operate in two to three additional states or insurance jurisdictions, in addition to their state of residence. They passively service commercial exposures for their insureds in an additional two jurisdictions. Over 25% of our member agencies operate regularly on a five-or-more state basis with several national insurance programs.

PIA member agencies are also directly responsible for securing the resident licenses of all designated employees, including the pre-licensing and continuing education, as well as licensing fees in all required lines of business and jurisdictions. Naturally, they are also responsible for their corporate and insurance business entity filings, again in all required jurisdictions. As owner principals, PIA members are also responsible for requesting appointment of their various staff with the carriers with which they are doing business.

Mr. Chairman, as you have asked us to do, PIA will outline some of the key competitive challenges faced by multi-state insurance producer operations, to include countersignatures laws.

Reforms for Producer Oversight:

PIA is absolutely committed to reform of the insurance oversight system, in a manner that maintains effective oversight for public protection. This includes solutions to the still existing frustrations with the producer licensing and oversight system.

However, meeting a minimum standard is not what PIA is after. PIA wishes to reform the whole system in a fair and balanced manner that equitably treats those producers that are only licensed and operate in one state (not the typical PIA member) and also creates appropriate open borders for the vast majority of independent insurance agencies and brokerage firms that operate daily in multi-states.

Why nothing less than the NAIC Single License Producer Model Act is acceptable as the foundation of reform:

The progress that has been made with the new NAIC Single License Producer Model Act (SLPMA) has been wonderful. PIA also fully appreciates the influential role played by GLBA/NARAB and continuing federal interests through subsequent hearings such as these, in pointing states toward the direction of their reforms and providing the encouragement and pressure to achieve these in a timely manner.

But state adoption of the NAIC SLPMA is only the first step. Along with others in the insurance community and the NAIC, the National Conference of State Legislatures (NCSL) and the National Conference of Insurance Legislators (NCOIL), we are moving forward on the next ring of regulations that must be changed countrywide and made more uniform.

While the issues we will note and discuss today are by no means the total list, they are issues that demonstrate particularly well the holistic cooperative requirement from many bodies of law.

NAIC SLPMA immediately reforms:
This NAIC model has not yet been adopted in all jurisdictions. Further, some of the states that have designated themselves as NARAB compliant by virtue of reciprocity only are states that have not had any previous reform/updating to past NAIC producer models. Hence, these minority jurisdictions still pose challenges in the following lead areas:

Countersignature Laws – In 1970, PIA adopted a position encouraging the repeal of these laws, recommending the type of replacement provisions that were needed to assure that an in-state person would be available for service of process and that state premium taxes would be properly accounted for. In 1972, PIA amended its policy to oppose these laws and work for their repeal.

In 1986, PIA further amended this position to make clear that we opposed not only countersignature (CS) laws, but also the secondary level of insurance statutes that, while not technically called or classified as CS laws, acted in concert to frustrate open non-resident participation. These would be laws that require a resident agent of the county in which the risk exists, deliver all insurance policies issued on exposures in the state. PIA's position on this issue was included in the 1987 NAIC revised Agent and Broker Licensing Model Act and the first NAIC Single-License Producer Model Act.

Much progress has been made on the repeal of the CS laws themselves; only a few remain. PIA appreciates and is sensitive to the unique market and public policy circumstances that exist in Florida and Nevada with regard to the use of their CS laws in a broader rubric of consumer protection. However, we submit that these issues can be solved without the CS law.

However, less progress has been made on the secondary level of statutes that acted in concert with countersignature laws. In some states, the per se countersignature law was repealed, but the companion statutes were not.

Example - As is many times the case, should a commercial client of mine secure a business operation in one of these states I would be required to:

Under countersignature laws:

- Secure the services of a resident, countersigning agent from that state that my client will not know, and whom I might not know either.
- This resident agent must already be licensed in this state to write the nature of coverage for client's new operation in that state, as well as already be appointed by the carrier with which the client already has placed all the other aspects of business operations outside that state.
- As the principal producer on the full account, I must still be sure that all forms and the carrier area authorized to write & issue the nature of coverage being secured.
- The in-state agent would then technically "place" the business through merely countersigning the policy form and collect a fee for service.

Under a state with the secondary statutes:

- I may be able to perform all the regular tasks and issuance of coverage for my client. However, the state law may require that I deliver a copy of the policy in full or for the specific exposure in that state to the business location and through the services of an in-state, resident agent operating in the county where the business is located.

Single license producer vs./ agent or broker license available: PIA, along with a core group of progressive regulators created the single license producer model concept. Adopted first in Missouri and Kansas in he early 1980s, we brought the concept to the NAIC in 1984 to set the stage for the first NAIC model. Unfortunately, we still have a number of jurisdictions that have yet to adopt this format. This is a problem because the nature of our business requires that we perform both functions for clients' insurance needs. Thus, in these states we are required to secure both agent and broker licenses as resident producers. As non-residents, we must select one or the other, thus limiting the type of activities to be performed for our client in that state.

Agent-only jurisdictions These jurisdictions do not recognize the broker/brokering status, something fundamentally required for the independent agency/broker property and casualty business and for our clients, whether on a resident or non-resident basis. This creates problems particularly on a non-resident filing. If in my resident state I am licensed under the single-license producer approach, and by nature of my business operations acting in a broker capacity, I would be forced to evolve into an agent for non-resident purposes in these jurisdictions –something that may not be possible or wanted because of the nature of my business.

Individual vs. Business Entity –PIA supports the availability of both an individual and insurance agency/brokerage business entity license. Under this approach all individuals engaged in producer activities are required to be individually licensed. However, in addition to that the insurance agency may also be subject to an insurance business entity license. Many, but not all states have adopted this approach, one reflected in the current NAIC model. In order for a non-resident system to be open – every insurance jurisdiction must have compatible types of persons being licensed. Today, several states only make available an individual producer license.

There are numerous public policy reasons why insurance departments should have both types of licenses. However, specific to non-resident filings in jurisdictions that still only have individual licenses available – it forces PIA member agencies that operate on a business entity basis to only have one of their individually licensed staff members file as non-resident in these states. This creates numerous legal, insurance appointment and tax issues for such agencies, and in PIA's opinion lessens the comprehensiveness of the state's regulator oversight of the insurance operation.

Reform Issues NOT Dealt with in the current NAIC model:
Foreign Corporation Filings: This is an example of other (non-insurance) government officials applying a one-size fits all solution to state tax problems caused by general commercial Internet activities.

Encouraged by concerns voiced by state Attorneys General and executed by the Secretary of State, persons operating in what we in insurance would consider a non-resident state must first file for and secure a foreign corporation license permitting them to enter the state. That process requires completing an application, paying a fee which is generally hundreds of dollars and, in some states, appointing an in-state law firm selected from a state provided list for a fee, again generally two or more hundred dollars, to act as the foreign corporation's office for service of process.

Once in the state, insurance producers must still go through the already established non-resident process that, for most states, involves taking their foreign corporation license and filing for an insurance nonresident business entity license, and then filing for the required individual licenses, paying all these fees as well.

PIA supports the insurance process. Insurance Departments have the structure, authority, expertise and experience with non-resident activity in their state for over 150 years. They have the system that the Attorneys General lacked in other areas of commercial activity in their state.

However, PIA wants insurance producers relieved of foreign corporation filings because they are duplicative of what we are already doing in the state and no other commercial participants are thus subjected. The costs of filing in these jurisdictions that are increasing monthly are as high as $1200 per license.

Background Checks: PIA has long supported quality background checks of all persons seeking an insurance license, to include officers and controlling interests of the insurance business entities. PIA worked on and supported H.R. 1408 to both support better access for our regulators to the broader federal criminal background files and correct the serious constitutional problems with 18 U.S. C. 1033/1035, with its disparate treatment of the insurance industry compared to the banking and equities industries. PIA is grateful to this Committee and its members for having the good sense and commitment to make the provisions contained in H.R. 1408 real.

However, while attempting to work out coordination issues with the NAIC to be used in The Several States and through the National Insurance Producer Registry (NIPR)*, there is a growing problem regarding a lack of coordination with the individual state Departments of Insurance as they independently expand their authorities and interfaces for these background checks on their own, with state criminal and single state access to federal criminal databases. Further, there is a sharp difference among states in that some require fingerprints and others do not. This becomes even more of a problem given the language of NARAB in GLBA.

Therefore, PIA Board adopted a position last September making it clear that we support H.R. 1408 as the process along with the one time, electronic fingerprinting of all persons currently licensed, and all applying for a license, in their resident state. This process should be recognized on a reciprocal basis for a non-resident license filings, as well. The one-time electronically collected and maintained fingerprints may be subjected to additional review if there is an investigation underway, the facts of which warrant this prudent action, or on a periodic basis – encompassing no more than 5-year cycle.

However, PIA is very concerned with the current system which is ink and paper oriented – where it exists. This process is a one-time, use-only process, subjecting our multi-state members to multi-fingerprinting process per year. Further, the explosion of fees tacked on by several state and federal agencies is again creating a cost-prohibitive system for either the agent/broker to afford directly, or even if those costs are shifted to carriers, which PIA does not support.

Solutions:

As stated earlier – all four forms of reform approaches are needed. This is why we have been working with NAIC/NCSL/NCOIL, PIA affiliates and other industry interests on proposals for all four areas. This includes a federal proposal, the details of which you will hear more in future hearings from our proposal partners, the Independent Insurance Agents and Brokers of America (IIABA). We see these efforts acting as a refinement and improvement on GLBA/NARAB, and supporting NAIC's et. al. current reform efforts in all these areas, providing us collectively with the support to get these reforms on the agenda of state legislatures. Further, for states that have not yet embraced the reform effort, this process would leverage them into the family.

However, optional federal charter proposals do nothing for these issues because of the dual-track nature of their concept. Most do not even address producer concerns in this area, and to fit their proposal's framework, they would most likely not work with NAIC, NIPR and all the current reform investment made in The Several States.

PIAs' Evolving Position on State Regulation:

On a daily basis, PIA member agencies, representing the typical independent retail insurance agency serving local communities must operate and comply with all the appropriate state and federal insurance and business laws that apply to their operations, in multiple jurisdictions. PIA members fully accept and support this multi-law application.

However, PIA members can no longer bear the cost and processing time of a dissimilar and conflicting multi-jurisdictional environment, and a compliance system that is outdated and does not move in rhythm with the pace of today's market.

But permit me to make it abundantly clear: this does not mean that PIA thinks the current system of insurance regulation is broken, cannot be fixed or should be eliminated. Quite the contrary -- despite its problems, the current state-based system is the most efficient vehicle for ensuring common sense regulation and competitiveness in the 21st Century. What is needed is reform to this system.

History of PIA Reform Efforts – When PIA began to introduce into The Several States for passage the 1977 NAIC Continuing Education Model Act, we learned many things about what was then the oversight system for insurance agents and brokers. One of them was that the system had not be reformed in most states since its inception over 100 years prior, and even in "progressive states" most statutes were over 50 years old.

So beginning in 1980, PIA National undertook the first full scale review and evaluation of the state insurance oversight system for insurance agents and brokers. Our purpose was to update and streamline the system. Working both with PIA's state affiliates and key progressive regulators in a number of states, and bringing this agenda to the National Association of Insurance Commissioners (NAIC), PIA led and chaired the NAIC-industry effort to create the first Single License Producer Model Act, as well as the concept of Continuing Education (CE) reciprocity. PIA worked state-by-state, most times alone with no other industry support, and was able to achieve these reforms in 28 states.

PIA has continued to actively participate in the creation and updating of associated NAIC models., The support and full commitment of PIA state affiliates has allowed us to carry that reform agenda through state legislatures. Sometimes these efforts have not been successful, due principally to differences of opinion among industry interests, but also because of conflicts with a state's insurance department or legislature.

Influence of GLBA – However, with the passage of the Gramm-Leach-Bliley Act in November 1999, PIA understood that we needed to express our support for the state oversight of insurance in a new way.

PIA fully appreciated that the passage of GLBA meant that Congress had formally and legally created the financial services industry, in which insurance was now a segment. Further, PIA knows from our experience with other federal insurance legislation (such as federal flood, crop, ERISA, Longshoreman's, black/white lung funds) that what Congress creates, Congress continues to "perfect" through further hearings such as this one, and follow-up legislative activities.

Additionally, because of the increasing multi-state (and some international) exposures of our members' clients' business, we realized what is needed is an insurance oversight system that moves in a more collaborative, collective, shared and uniform manner. The systems structure and pace must also be compatible with a today's fast-moving and rapidly evolving marketplace. Lastly, it has to be a system which better complements and coordinates with the growing federal insurance component.

Therefore, in May 2000, March 2001, and again in September 2001, the PIA National Board of Directors:

(1) restated its support of functional-state regulatory oversight of the insurance sector;
(2) (2) that reform of this sytem achieve a collaborative, shared-resources, uniform, effective system better coordinating with the other federal and state financial services regulators, and related aspects of state and federal laws
(3) (3) to use all all four methods of reform, i.e. (a) NAIC/NCSL/NCOIL model acts; (b) state-by-state legislative/regulatory actions; (c) leveraging more quickly and uniformly, as well as driving further depth of reform through the use of multi-state compacts; and (d) bettercoordination e with current and continuing federal efforts.

This four-prong coordinated approach to reform creates a whole, single system operating by the same rules, directed toward the same purpose and processes.

As PIA's words and actions have demonstrated, we are committed to real, meaningful, speedy and successful reform of the oversight system for insurance. PIA believes the whole system must be reformed in a manner that makes it more uniform and contemporary in its public policy meaning and effectiveness, as well as processing and serving the speed and competitiveness needs of licensed/regulated constituents.

Why State – The bodies of law to which our policies must respond are primarily state-based legal systems: contract, tort, property, health, family law, inheritance, etc. Therefore, the state court system is broad, deep and generally consistent in its demand relative to the meanings of our policies and expectations as respects our industry practices. This has been reflected in the detail of the state-by-state insurance regulatory system, one that is far more detailed than any other industry sector in the economy.

Also, the state oversight system is closer to the people who are in a better position to know and reflect state court decisions. As has been demonstrated in property and casualty and health insurance, market conditions and other issues may arise, affecting one state or region of the country in a unique fashion, different from other geographic areas. Consequently, there is always a need to be immediately responsive in a targeted manner.

These conditions best play to the strengths of state regulation.

Why federal – PIA appreciates the unique role that the federal government either needs to play or decides it will play in insurance related matters. As a result, current federal law related to insurance is a daily reality in PIA members' operations. Also, it is daily complicating the marketplace because, by and large, it is not written to relate, connect, complement or integrate with the existing rubrics of insurance law, be they statutory or common law. It also does not recognize or appreciate the required coordination insurance law must have to other bodies of state-oriented common law to which many insurance participants are responsible.

Why coordinate- It is imperative that we create understanding and legal refinements and improvements to bring both the existing and future federal obligations impacting insurance into alignment with these other material, significant bodies of state law. This needs to be done while still reforming the state functional oversight system of insurance, as well. The end result must form a single, cohesive and far more successful regulatory oversight structure for the public, regulations and participants.

As PIA Board members put it to our staff during our September Annual Board meeting, we understand that despite what we'd like, there will be these four areas of active ongoing reform to insurance. At the end of the day, it is your job to be sure that all four end up in the same place and create one understandable system. And the best way to do that is to be involved and contribute to all four, working them into coordination.

PIA Opposes Federal Optional Charters:

PIA has and will continue to oppose federal optional charter proposals, because at their core of purpose and practice they are meant to be a two-tier, shadow insurance system that runs parallel to the current system. They create, at best, a federal competitive system with The Several States and at worst, invite or create conflicting rules and processes. This adds a 56th insurance jurisdiction to our members' current 55-insurance jurisdiction compliance reality.

Further, the federal optional charter concept naively and incorrectly assumes that because some financial service operations can more easily select exclusive participation in the federal system over the state system, or vice versa, this means that servicing the insurance needs of consumers will be cleanly split between these two worlds, and that "federal consumers" will be marketed and serviced by producers that only represent federal entities, and vice versa. This is an understandable view if one only looks at the marketplace, applying a singular organization to insurance company operations.

However, insurance products are designed to serve the constantly varying needs of consumers who live and work at the floor of the marketplace and in every state, with occasional needs outside the United States. As a result, any producer that commits themselves to the independent insurance agency and brokerage system -- irrespective of their size -- knows that they have always had a mix of carriers and carrier types, i.e. alien, national, regional, single-state, county, reciprocal, cooperatives, national purchasing groups, risk retention groups, other forms of self and group insurance, as well as admitted, non-admitted and alien-registered trust companies, not to mention some federal insurance programs.

Not all PIA member agencies need all these types of insurance offerings or entities at all times. But all PIA member agencies deal with several of these types and over time, most PIA member agencies will have dealt with all these types in order to best meet the insurance needs of their clients and communities, through all types of market, economic and carrier appetite conditions.

So therefore, PIA members always have and for the foreseeable future always will be representing a mix of these carriers, which in part are not now subject to the same regulatory oversight, statutes or process, and which will only be exacerbated under a federal optional charter structure. Consumers, as well as agents and brokers, will need to add to their placement assessment:

- Financial soundness
- Quality of coverage and practice
- Reasonably competitive price
- Scope of underwriting class and insured profile tolerance
- Federal or state regulatory system – which is of best benefit?

This is not an evaluative assessment that most consumers can make, will have the time to make, or should be forced to make, by financial service entities desiring this system for their own competitive advantages and corporate structure needs.

Insurance carriers need, and have at will exercised, their right to change their underwriting appetites to respond to overall changing market conditions, as well as their own internal corporate needs. Accordingly, a particular course set by many carriers may not be the course they will continue in three or so years. Current market conditions and carrier behaviors as a necessary response to the market pressures, exacerbated by the September 11 events and the lack of full Congressional action on a federal backstop for terrorism insurance, is a perfect example to illustrate our point.

Independent agents and brokers who are committed to a broad and varied access to insurers for their clients' needs better allow carriers to make these modifications without catastrophic market dislocations.

Adding a choice between federal vs. state oversight systems to the already complicated and challenging maneuvers required to be undertaken when an agency or brokerage transfers business to a new market or carrier, does not serve consumers or the economy. Of course, it may serve the competitive plan of a particular financial services entity, but PIA does not believe that is the purpose of policy or federal law.

Thank you very much for the opportunity to share with the Committee PIA's actions and concerns on this important issue.

United States House of Representatives
Committee on Financial Services

"TRUTH IN TESTIMONY" DISCLOSURE FORM

Clause 2(g) of rule XI of the Rules of the House of Representatives and the Rules of the Committee on Financial Services require the disclosure of the following information. A copy of this form should be attached to your written testimony.

1. Name: Steve Harter	**2. Organization or organizations you are representing:** National Association of Professional Insurance Agents (PIA
3. Business Address and telephone number: RR5 Box 438 Ava, Mo 65608 417-683-4084	
4. Have you received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2000 related to the subject on which you have been invited to testify? ☐ Yes ☒ No	**5. Have any of the organizations you are representing received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2000 related to the subject on which you have been invited to testify?** ☐ Yes ☒ No
6. If you answered "yes" to either item 4 or 5, please list the source and amount of each grant or contract, and indicate whether the recipient of such grant was you or the organization(s) you are representing. You may list additional grants or contracts on additional sheets.	
7. Signature:	

Please attach a copy of this form to your written testimony.

INSURANCE REGULATION AND COMPETITION FOR THE 21ST CENTURY
STATEMENT BY MICHAEL D. PHILLIPUS
OF THE RISK AND INSURANCE MANAGEMENT SOCIETY
BEFORE THE SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND GOVERNMENT SPONSORED ENTERPRISES
COMMITTEE ON FINANCIAL SERVICES
UNITED STATES HOUSE OF REPRESENTATIVES

RICHARD BAKER, CHAIR

June 4, 2002

Good afternoon Chairman Baker, Congressman Kanjorski and Members of the Subcommittee. My name is Michael Phillipus. I am the Vice-President of Communications and External Affairs for the Risk and Insurance Management Society (RIMS), the largest professional organization for the risk management community. I appreciate the opportunity to appear before you today on the issue of insurance regulation and competition for the 21st century.

RIMS member companies, which comprise over 4,000 consumers of commercial insurance, support the advancement of efficient insurance purchasing abilities. RIMS membership spans the country and consists of entities of all different industries and size, including 84 percent of the Fortune 500 companies, as well as approximately 950 companies with less than 500 employees.

The job of a risk manager is to protect and preserve physical, financial, and human resources. One of the primary means of accomplishing this job is through the purchase of insurance. Risk managers, therefore, must become experts in the various insurance vehicles available to determine which will provide the best coverage at the most reasonable price. The first hard market of the 21st century has made this job even more difficult, and risk managers are forced to be more creative in minimizing risks to their employer. Sometimes, traditional insurance coverage is inadequate or simply unaffordable for all or part of a company's holdings. More and more often, risk managers are turning to alternative markets to procure necessary coverage. According to the *Risk Retention Reporter*, A.M. Best expects that in 2003, the alternative market will comprise nearly 50 percent of the U.S. commercial insurance market.[1]

Captive insurance companies are an important part of the alternative insurance market. Captives are closely held insurance companies whose insurance business is primarily supplied and controlled by it owners, who are also the principal beneficiaries. Captives are crucial because they allow a sophisticated insured to control their risk/insurance destiny in a manner that provides stability and emphasis on loss control and risk integration.[2]

Captives are formed in jurisdictions that have specific laws for their formation, which are different from laws governing other traditional insurance companies. There are many different types of captives, including single-owner captives, group captives, association captives, insurance agency captives, rent-a-captives, protected cell companies, virtual captives, captive pools, and risk retention groups.

Captives may be created in domestic or foreign jurisdictions. According to the 2000 A.M. Best Captive Directory, there were 4,199 active captives in 1999.[3] Of the total number of captives, 678 were organized in the United States. According to the 1999

[1] *Risk Retention Reporter*, May 2002.
[2] ARM 54, "Essentials of the Risk Management Process," and ARM 56, "Risk Finance," CPCU Institute.
[3] 2000 A.M. Best Captive Directory.

statistics, Vermont, Hawaii, and Colorado have the largest numbers of U.S. captives; Vermont dominates with 368. Many states are adopting captive laws to attract captives, the latest being Nevada, South Carolina, and the District of Columbia.

There are a number of advantages for establishing captive insurance companies:

1. Operating costs can be reduced; thereby permitting increased profits to be utilized by the captive. As compared to a traditional insurer, captives can generate a bottom-line expense savings of 5 to 25 percent.[4]
2. Since they are subject to fewer restrictions, captives can also provide more flexibility in the coverage offered to their participants. They can develop their own policies and forms, so that they can offer coverages that are not available from traditional insurers.
3. Captives provide their owners with direct access to reinsurance, which is far more cost efficient than through the traditional insurance market. Generally, an insured cannot access the reinsurance market directly without the use of a captive.
4. Captives can lessen the volatility of the traditional market on their participants. Participants also have some assurance of stability of premiums, amount of deductibles, and retentions and coverage terms.
5. Captives have to deal with fewer regulatory restrictions than the heavily regulated traditional insurers. This is because the policyholders are owners of the captive

[4] Risk Financing, International Risk Management Institute, Inc., Dallas, TX.

and there is no reason to protect the policyholders from themselves. This results in significant cost savings for captives and flexibility in policy terms.

Risk retention groups are a form of captive insurance companies. These groups provide certain insureds with a casualty approach on a homogeneous basis that removes their risk from volatile industry cycles, as well as focused service customized to their exposures. Authorized by federal law, they are incorporated under state law and governed by the law of the state of domicile.[5] The federal authorizing statute was approved originally in 1981 to address the inability of companies to purchase product liability insurance.[6] The law was amended in 1986 to broaden the purposes for which risk retention groups and risk purchasing groups could insure to include all lines of liability coverage except personal lines and statutory workers' compensation coverages.[7]

Companies having a common risk exposure may form risk retention or risk purchasing groups. While capital and other requirements for forming a risk retention group are governed by its state of domicile, states in which a risk retention group does business may conduct financial examinations and require evidence of solvency, and the risk retention groups are subject to state unfair claims settlement laws.

There are approximately 75 operational risk retention groups. The annual premium written by risk retention groups in 2001 was almost 1 billion dollars.[8]

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[5] 15 USC, Section 3901.
[6] Product Liability Risk Retention Act of 1981.
[7] Liability Risk Retention Act of 1986.
[8] *Risk Retention Reporter*, May 2002.

Risk retention groups continue to grow rapidly and fulfill an important part of the alternative market.

The Liability Risk Retention Act (LRRA) does not permit risk retention groups to underwrite property insurance. This limitation reduces the number of insurers that could underwrite property insurance at a time when market restrictions from terrorism threats, combined with a hard market, have driven prices up and reduced availability.

RIMS urges Congress to expand the LRRA to permit risk retention groups and risk purchasing groups to write all coverages except personal lines and direct statutory workers' compensation coverage.

In order to adequately insure unique, difficult-to-place or high capacity insurance risks, risk managers frequently use the surplus lines (sometimes called the excess lines) market.

The surplus lines market is formed by a provision found in every state's (including the District of Columbia) insurance code that allows risk managers or other insurance buyers access, through specially licensed insurance brokers, to non-admitted (unlicensed) insurance companies when the state's licensed or admitted insurers are unable to fulfill the buyer's insurance needs.

Rather than an alternative market, the surplus lines market is better described as a "supplemental market" to the licensed/admitted market. The surplus lines market, in effect, serves as an outlet or "safety valve" market to be utilized by risk mangers and their brokers when the desired coverage cannot be found among the state's admitted/licensed insurers or when market forces or conditions in the admitted/licensed market cause voids and gaps to occur in coverage for certain types of risks.

The key element or defining characteristic of the surplus lines market is its "freedom of rate and form," (i.e. the ability of the non-admitted surplus lines insurers to provide policies and coverage free of state rule, rate and form requirements). Freedom of rate and form is essential for the surplus lines market to have the flexibility to quickly and adequately respond to the risk manager's insurance needs particularly for hard-to-place, distressed, unique and high capacity (high limit) risks.

Historically, the surplus lines market has served as a crucible for the development of new and innovative insurance products. Coverages such as umbrella liability, difference in condition (DIC), claims-made professional liability, asbestos abatement liability, liability coverage for radon testers, employer practices liability insurance, and e-commerce liability coverages, many of which are now standard products in the licensed/admitted market, were first developed, tested and sold in the surplus lines market.

It is frequently stated that the surplus lines market is "unregulated." This is not the case. While the market is free from rate and form regulation, the surplus lines market is a regulated marketplace.

Although regulated differently than the licensed/admitted market, there are a number of rules, requirements and protections surrounding a surplus lines placement. In fact, the regulation of a surplus lines transaction can, on occasion, entail time delays and inefficiencies that make the surplus lines market unattractive to a buyer who may then resort to other mechanisms or alternatives to obtain coverage.

The focus of surplus lines regulation is on the specially licensed surplus lines (or excess lines) broker. Access to the group of non-admitted carriers that form the surplus lines market can only be obtained through the specially licensed surplus lines (or excess lines) broker. The licensed surplus lines broker is restricted to using non-admitted insurers that meet certain statutory minimum capital and surplus requirements and other standards. The financial requirements for eligible surplus lines insurers are generally equal to or in excess of similar requirements established for licensed/admitted companies.

In thirty-five states, a surplus lines broker's placements or transactions are restricted to only approved non-admitted companies whose name appears on a list published by the state insurance department. This list is known as an "eligibility list." In the other jurisdictions, the surplus lines broker assumes the responsibility for placing the business with non-admitted carriers that meet the statutory/regulatory requirements established by the state.

Before a surplus lines broker can obtain coverage from a non-admitted carrier, the risk for which the coverage is sought must be submitted to and be declined by the admitted market through what is known as a "diligent search" or "diligent effort" process. It is common for a state to require that a minimum of three companies, which are licensed to write the type of coverage sought, decline to accept the risk before a surplus lines broker can place the coverage with an eligible surplus lines insurer. Moreover, in some states, a surplus lines placement is prohibited if it is done to obtain a lower price or rate than the "average" or lowest-filed rate in the state. Similarly, a surplus lines placement cannot be made, in many states, simply to obtain a more favorable form.

After a surplus lines placement is made, each state requires that the transaction be reported to the insurance department by the placing surplus lines broker, and that the broker remit the taxes due on the transaction. Often these reports can be accomplished on a quarterly or other periodic basis. However, in some states, the report is required on a transaction-by-transaction basis. These reports are usually in the form of an affidavit and, in a few states, the insured or applicant is also required to sign the affidavit.

In all but two states, the surplus lines broker is required to affix a "legend" or "stamp," to the policy containing statutorily specified language. While the language varies from state to state, the purpose of the "legend" is to inform the reader that: 1) the policy is from a non-admitted or surplus lines insurer; 2) the state does not regulate the insurer; and 3) that in the event there is an insolvency of the company, there is no guaranty fund protection for the policyholder.

Except for the state of New Jersey, which in 1983 established a separate guaranty fund for surplus lines, no state offers guaranty fund coverage for surplus lines policies. The reason that surplus lines carriers are not part of state guaranty funds is that as non-admitted or unlicensed insurers, they are not eligible for inclusion in the guaranty funds established for admitted or licensed carriers.

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In discussing the surplus lines market, state regulators are always quick to point out the lack of guaranty fund protection in the surplus lines market. From a risk management perspective, this fact should be placed in context.

First, state guaranty funds have "claim caps," of $100,000 to $300,000 per claim. These caps are well below the limits of many commercial insurance policies making the guaranty fund coverage for these policies of lesser importance. Secondly, from a risk manager's perspective, the solvency of the insurer is as significant an issue as is guaranty fund protection. Based upon the A.M. Best *Annual Review of the Excess and Surplus Lines Industry*, which has been published annually since 1994, the solvency of the surplus lines market has been as good as, or better than, the admitted market for the last thirty years.[9]

The first surplus lines law was enacted by the state of New York in 1890. That law focused on regulating a specially licensed broker who would only deal with specified non-admitted carriers, and would have to perform a search of the licensed market before a risk could be insured by a surplus (or excess) lines carrier. The basic concepts contained in the 1890 New York law have been replicated and are contained in virtually all other state surplus lines laws.

At the time the original New York surplus lines law was passed, the major surplus lines insurer was Lloyd's of London and insurers based outside of the U.S. – alien

[9] A.M. Best Company * Special Report (September 1994), Insolvency Study of the Excess & Surplus Lines Industry, p. 14; A.M. Best Company (September 2001), Annual Review of the Excess & Surplus Lines Industry, pp. 21-24.

carriers – dominated the surplus lines market. Today, according to A.M. Best, surplus lines represent over eleven and one-half billion dollars in annual premium with 70 percent of the surplus lines premium flowing to U.S.-based carriers that are regulated for solvency by the company's domiciliary state, as is any other insurer licensed in that state.[10] Lloyd's of London only writes 15 to 25 percent of the annual surplus lines premium volume.

Moreover, in 1890, the drafters of the New York surplus lines law did not contemplate that the surplus lines business would cross state lines. In contrast to 1890, a majority of risks insured through the surplus lines market today, cross state lines and have multi-state exposures.

This multi-state aspect of surplus lines risks poses difficulties for the surplus lines market under current state regulatory laws. First, there is the difficulty of compliance by brokers, with a variety of differing state regulatory laws, should a risk or surplus lines placement cross state lines.

Second, and most problematic, is the difficulty multi-state risks pose for the broker in the remittance and compliance with the state surplus lines tax laws. Under state surplus lines tax laws, the onus is on the surplus lines broker to remit taxes on surplus line premium to the states. Unfortunately, the state surplus lines premium tax laws are inconsistent, conflicting and in some cases, vague as to how the tax is to be determined and paid. For example, in most states the surplus lines broker is expected to allocate

[10] A.M. Best Company (September 2001), Op. Cit. p. 12.

surplus lines premium to the states in which exposures exist, and remit a tax on that portion of the premium. However, there are a few states that demand a tax on the entire premium regardless of where the exposure exists. This creates conflicting demands and the possibility of double taxation. More significantly, however, is the fact that there is no accepted allocation formula among the states, making it difficult to know how to calculate the tax due.

Finally, some states apply their surplus lines tax laws in a manner that appears to be inconsistent with the 1962 U.S. Supreme Court decision in Todd Shipyards that holds that a tax on a wholly out-of-state insurance transaction is invalid.[11] These surplus lines tax issues are of concern to risk managers when dealing in the surplus lines market.

RIMS believes that self-insurance will continue to be a popular coverage choice in the 21st century; in part due to conditions in the insurance marketplace which restrict the purchase of coverages because they are unavailable or priced too high (i.e., terrorism insurance). Companies can calculate expected losses in many areas of operation and then fund those losses through self-insurance, thereby eliminating the cost of traditional insurance (overhead, profits, reserving practices). Excess insurance coverages may increase in the future as coverage is sought for the portion of potential losses that cannot be self-insured or self-funded.

In addition to the alternative markets discussed today, this Congress has the ability to provide another choice, one that is surely not without controversy, yet with the

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[11] State Board of Insurance,et al. v. Todd Shipyards Corp., 370 U. S. 451 (1962).

potential to eliminate a significant amount of the costs and time that have driven up prices in the traditional insurance market – an optional federal insurance charter.

RIMS recognizes both the incredible promise, and the inherent hazards, of an optional federal insurance charter. The Society appreciates the serious and complex implications of allowing insurers to obtain a federal license that would allow them to operate nation-wide without regard to individual state laws.

But, despite the significant hurdles that must be overcome in developing an optional federal charter, the goal of all parties involved should be a cost-effective, quality insurance product that is easily obtainable. The current system in the United States is inefficient. Negotiating rate and form regulations in 50 different jurisdictions is expensive and time-consuming. A single regulator to establish risk-based capital and surplus requirements, as well requirements for public disclosure of rates and forms, would reduce costs and restrictions for U.S. purchasers, and act as an incentive for increased participation by foreign companies.

In addition, a federal presence in the insurance industry should not intensify the regulatory burden on U.S. businesses. One of the dangers of an optional federal charter is that the federal mechanism will become just another over-large, Washington bureaucracy. A federal regulatory option should not develop into the 51st state. Also, the state regulation system needs to remain accessible to those insurers who do not choose to participate in a federal option. Ideally, an optional federal charter would spur improvement and innovation at the state level.

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Insurance regulation and products should reflect the technology and sophistication of the new millennium and the global market. The 20th century regulatory system in the U.S. cannot adequately compete in the 21st century worldwide insurance marketplace. Gramm-Leach-Bliley, and the subsequent convergence of financial institutions, heralds an unprecedented evolution in U.S. banking and business. Insurance regulation should be a reflection of this advanced, streamlined, and market-based environment.

RIMS supports a consultative role for the National Association of Insurance Commissioners (NAIC) in the creation of an optional federal charter. The NAIC has taken measurable steps to reform state insurance regulation, most notably the adoption of the state certification program, speed-to-market initiatives, and steps to deregulate commercial lines of insurance. By the very nature of state regulation, however, it is almost impossible to achieve uniform laws and regulatory interpretation of those laws. Nevertheless, creation of an optional federal charter should involve the NAIC on a consultative basis to ensure that states' rights and revenue issues are properly addressed. RIMS continues to support the NAIC state accreditation system.

There are many questions surrounding an optional federal charter, and recent proposals provide a starting point for further deliberation. I am optimistic that this hearing and future hearings will begin a serious debate on this issue. RIMS understands that it may be a long road to approve optional federal charter legislation, but we believe that the time for this idea to become reality is now.

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In the end, all of these risk-financing options are crucial to risk managers. But there is no one-size-fits-all solution for commercial insurance consumers. While the alternatives discussed today provide some relief, RIMS ultimately favors a system unfettered by over-reaching government regulation, one that has the flexibility to respond to the varied needs of the consumer and the changing marketplace. Certainly, small and mid-sized companies benefit from the oversight protection provided by the state insurance regulation system. But care must be taken that this system does not restrict the movement of product and the ability of consumers to obtain adequate and affordable coverage.

Thank you for the opportunity to speak today. I appreciate your time, interest and leadership.

**RIMS would like to acknowledge the efforts of Dick Bouhan (National Association of Professional Surplus Lines Offices) for his assistance in preparing the section on surplus lines.*

Michael D. Phillipus, ARM

Vice President - Communications & External Affairs 2002-2003

Michael D. Phillipus was named manager of risk management of Pennzoil-Quaker State Company when the merger of the two companies was completed in late 1998. He began his career with the Progressive Corporation in 1981, after graduation from Rice University in Houston, Texas. Mr. Phillipus joined Pennzoil Company in 1985 as administrator of risk management and was promoted to senior administrator in 1988. In 1990, he was promoted to casualty risk manager, a position he held until the merger with Quaker State Company. In his current position, he is responsible for the placement, administration and review of the worldwide insurance program for Pennzoil–Quaker State Company and its subsidiaries. Mr. Phillipus is president and director of Savannah Company Limited, Pennzoil-Quaker State's captive insurance company subsidiary.

Mr. Phillipus has been a member of the RIMS Houston chapter since 1985. In 1989 he was elected as director of the Houston chapter and served as president of the chapter in 1995. He has also served the Houston chapter of RIMS as an instructor for the "Essentials of Risk Management" and the "Essentials of Risk Financing" classes. Mr. Phillipus also serves as director of the Global Risk Management Institute and serves on the Institute's Education Committee. He is a member of the ARM advisory committee of the AICPCU/IIA. Elected to the Executive Council in 1999, he has served as vice president - education, vice president - external affairs and currently serves as vice president - communications & external Affairs.

In October 1994, he served as a participant in RIMS international committee meetings with reinsurers in Munich and Zurich. In 1997, he joined RIMS' international committee and served as vice chair of the international relations committee. Additionally, Mr. Phillipus has served as a speaker and panelist at various industry and risk management conferences.

At the 1998 San Diego RIMS Conference, Mr. Phillipus received the first "Heart of RIMS" Award. This award recognizes a deputy member who exhibits qualities that further risk management at the chapter level.

Mr. Phillipus is a member of ACE's service advisory council, an interactive group of risk managers that reviews all areas of special risk, including claims handling, risk management information systems, loss control and other aspects of the special risk facilities services.

Mr. Phillipus earned the Associate in Risk Management designation from the Insurance Institute of America. Mr. Phillipus is a Texas licensed risk manager and All-Lines insurance adjuster.

United States House of Representatives
Committee on Financial Services

"TRUTH IN TESTIMONY" DISCLOSURE FORM

Clause 2(g) of rule XI of the Rules of the House of Representatives and the Rules of the Committee on Financial Services require the disclosure of the following information. A copy of this form should be attached to your written testimony.

[illegible]	[illegible]
Michael D. Phillipus	Risk and Insurance Management Society Inc
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655 Third Avenue New York, NY 10017	212-655-6046
[illegible]	[illegible]
☐ Yes ☒ No	☐ Yes ☒ No
[illegible]	
[illegible]	
Michael D. Phillipus	

Please attach a copy of this form to your written testimony.

STATEMENT OF

ANN SPRAGENS

SENIOR VICE PRESIDENT AND GENERAL COUNSEL

ALLIANCE OF AMERICAN INSURERS

ON INSURANCE REGULATION AND COMPETITION FOR THE 21ST CENTURY

BEFORE THE

HOUSE COMMITTEE ON FINANCIAL SERVICES

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE

AND GOVERNMENT SPONSORED ENTERPRISES

JUNE 4, 2002

Introduction

Mr. Chairman, Ranking Member Kanjorski, and members of the Subcommittee, my name is Ann Spragens. I am Senior Vice President and General Counsel of the Alliance of American Insurers, an association of 335 insurance companies.

I am here today to express our strong conviction that the public policy objectives of insurance regulation can best be met by improving, not abandoning, the state system. Also, I have been asked to discuss how state regulation of insurance is funded, and how such funds are allocated to state regulatory functions.

Today, insurance companies, producers, consumers, and regulators face an array of economic and political conditions that compel a re-examination of the current system of state-based insurance regulation. These challenges include the emergence of new competitors and competing regulatory priorities associated with implementation of Gramm-Leach-Bliley, industry frustration with current regulatory practices and resulting inefficient and often redundant or inconsistent requirements, the competitive imperatives of e-commerce, and the economic pressures associated with market consolidation and increasing globalization.

Of these, the inefficiencies and delays in state regulatory processes - as much as the outdated model of state regulation - bear most of the blame for the unacceptable condition of insurance regulation today. The status quo is being rejected by virtually every stakeholder, including insurers, producers, consumers, and many regulators. Without timely and significant reform, state insurance regulation will be at risk of becoming an anachronism.

While some in our industry and the Congress have called for federal regulation or an optional federal charter, the Alliance believes that the goals of insurance regulation - to assure consumers that the promises made to them will be kept, that insurance will be sold at a fair price, and that the company they bought from remains financially strong - can best be met by improving, not abandoning, the state system.

Funding of State Insurance Regulation

I would like to spend a few moments addressing your questions regarding how state insurance regulation is currently funded. Insurance departments raise revenue for their states through various licensing, filing and examination fees received from insurers and insurance producers. These fees are substantially augmented by the states' collection of premium taxes, generally one to two percent of the prior year's written premium. Some variance exists across the states as to how these funds are allocated to insurance regulatory functions. In most states, fees and taxes flow into general revenue for subsequent legislative appropriation to the insurance department budget. A number of states have implemented dedicated funding whereby fees collected flow to an account dedicated to the department's budget supplemented by the annual appropriation process.

In the 1999 Insurance Department Resources Report, published by the National Association of Insurance Commissioners (NAIC), aggregate budget dollars made available to insurance regulators totaled approximately $839 million in 1999 to cover in excess of 10,000 employees and some 1400 contract examiners and consultants. These figures have increased in recent years as states have enhanced certain regulatory functions, especially in the areas of solvency regulation and computerization, but have begun to level off. As one would expect, the cost of regulation varies from state to state based upon the relative size of the state's insurance market, its population and demographics, and the number of domestic insurers. For example, in 1999, California had 1,243 employees and a budget in excess of $129 million, while Wyoming retained a staff of 25 on a budget of $1.3 million. The large market states of California, Illinois, Florida, New York and Texas employ similarly large professional staffs to carry out regulatory functions.

State insurance regulators have the necessary resources to regulate effectively. However, the question is not only one of sufficient budget dollars. Whatever the regulatory model, the real issues revolve around the appropriate and efficient allocation of regulatory resources to those functions that truly effectuate the goals of insurance regulation. Budget comparisons between state insurance regulators and the other functional regulators of financial services at the federal level are less than meaningful. They regulate different industries - subject to different market dynamics and different laws - with a substantially different mix of regulatory objectives and functions.

Improved State-based System of Regulation

As noted earlier, some in our industry and the Congress have called for federal regulation or an optional federal charter. The member companies of the Alliance believe the goals of property and casualty insurance regulation - to assure consumers that the promises made to them will be kept, that insurance will be sold at a fair price, and that the company they bought from remains financially strong - can best be met by improving, not abandoning, the state system. Let me explain why.

State regulation of insurance is a product of our federal system of governance. Federalism reserves to the states powers not expressly granted to the central government – and for good reason. As the Founding Fathers believed in 1787, the sovereignty of the states, especially in the areas of civil and criminal law and the administration of the courts, would become a bedrock principle for our country, even as we enter the 21st century.

The states have a constitutional prerogative to establish liability systems and similar laws to promote social responsibility. Since property and casualty insurance is so closely associated with the tort and contract laws of the states, it follows that insurance regulation should remain state-based. For example, liability laws affecting automobile reparations, workers compensation, property damage, and personal injury differ from state to state, reflecting diverse public attitudes about responsibility and compensation. Insurance products are designed and priced differently in each state to account for these differences. At its best, state insurance regulation is adaptable to changing notions of public policy or to competitive pressures of the industry.

The best characteristics of the state system, including diversity, innovation, and responsiveness, would be lost in a federal or national model of insurance regulation. Federal or national models imply a single uniform set of rules applying equally across all states and all insurance markets. It is difficult to imagine a single regulatory system working in harmony with the diversity of underlying state reparation laws and differing public expectations about the role of insurance regulation. For example, will an open and competitive rating law work in a state with a tradition of subsidizing urban drivers? How responsive would federal regulation be to market dislocations in individual states caused by unique weather patterns or unusual interpretations of law? Can market conduct be fairly assessed by a federal regulator unfamiliar with the underlying state property and insurance laws?

That the states are better positioned than the federal government to accommodate diversity or to respond to change is not a full defense, however, to the charge that insurance regulation has failed in recent years to adapt to changes in the industry and the markets it serves. Significant weaknesses exist in state regulation today. Unnecessary distinctions among the states and inconsistency within states - in the areas of company admissions and agent licensing, for example - reduce predictability and add costs. Similarly, outdated rules and practices, particularly those that interfere with the product design and pricing, do not serve the goals of regulation in a modern financial services market.

What is needed is a new regulatory model - one that builds on the states' inherent strengths to meet the challenges of rapidly changing insurance environment. The new regulatory model must respond, for example, to the reality of e-commerce. Regulation that impedes this will force customers out of insurance markets to other financial services providers. Consolidation and globalization are forcing companies and their regulators to take a more integrated view of holding company regulation that is neither protectionist from the perspective of foreign carriers nor an impediment to domestic carriers to grow and more favorably compete in world markets. Constrained by outdated regulations, traditional insurance markets and products are giving way to alternative markets. The new regulatory model must respond faster and more fully to these emerging trends.

Significant and immediate improvements to state insurance regulation, particularly in the areas of company licensing, financial regulation, corporate governance, and rate and form filing efficiency, can be made without extensive statutory changes. More fundamental change such as a shift away from a prior approval model to a competitive one relying on market based pricing and product design will require legislative action. Critical to the success of state regulatory reform is the recognition and adoption by the NAIC and by the individual states of a "best practices" model with clear accountabilities, and explicit and significant reliance on regulatory collaboration and comity, including shared resources and the use of a "lead state" regulator, when appropriate - all consistent with state sovereignty and the principles of federalism.

For example, financial analysis, mergers and acquisitions, holding company transactions are all areas where regulatory principles are well established and nearly uniform across the states. However, the filing and approval processes are often quite different and introduce unnecessary complexity, delay and cost. Reliance on the domestic regulator for financial analysis and for holding company transactions makes sense, as does the use of standard forms and procedures for change of control and similar matters.

For rate and form filing in prior approval states, a set of best practices, including standardized review elements and timeframes, should be utilized. Electronic filing should be expanded. The NAIC's System For Electronic Rate and Form Filing System (SERFF) is one system for e-filing. It should be enhanced to accommodate multi-state filings as well as single state submissions and provide a direct electronic interface for insurers to use to minimize rekeying and other obstacles to easy use. Multi-state filings offer particular opportunities for advances to harmonize filing requirements in an environment where regulatory collaboration in the form of multi-state review teams could simultaneously review a filing subject to common information requests and common timeframes for review and disposition. While e-filing holds promise for the expedited flow of information, without improvements to the review process itself or the relaxation of filing and approval requirements, SERFF alone will not sufficiently improve speed to market conditions.

We would expect all states to immediately begin moving away from prior approval regulation for insurance rates and forms, particularly for commercial lines. While we believe a competitive market is the best regulator or product and price for all lines or insurance, we recognize that a modest level of rate and form regulation for personal lines may be perceived as desirable in some states. The Best Practices model should be expanded over time so that notions of competitive pricing and informational form filing are, themselves, elements of the model.

Important reforms of producer licensing laws are necessary and achievable, as they enjoy broad support from among producers, carriers, consumers and regulators. However, it is critical that uniform and commercially rational definitions of "sell, solicit or negotiate" continue to be adopted in the form of the NAIC Producer Licensing Regulation so that license requirements are not based on increasingly dated notions of how insurance products should be marketed.

The new regulatory model should rely less on front end regulation and more back end or market conduct regulation. Market conduct is an area that lends itself well to the emerging changes in insurance regulation. Adherence to best practices promotes efficient behaviors on the part of carriers and regulators and reduces the chance for error. To fairly and effectively measure carrier performance, market conduct examinations, themselves, should be subject to best practices protocols.

State insurance regulators, through the NAIC, are making significant progress on their reform agenda to modernize state insurance regulation. This agenda, for the most part, reflects the themes I have put forward today. However, it is critical that the reform debate now move to the state capitols where the insurance commissioners must lead the effort to redesign and modernize state insurance regulation.

Conclusion

Mr. Chairman, I appreciate the opportunity to appear before this Subcommittee today. I hope that my remarks illustrate to you how a modernized, state-based system of property and casualty insurance regulation can best address the challenges of today's insurance market in ways that result in a system that is genuinely improved, not merely preserved. This Subcommittee's efforts to explore these issues and to provide oversight of progress made on state reform initiatives will play a constructive role in moving the states to further action.

Thank you.

Tax Collections by States Tumble As Effects of Recession Are Felt

By Robert Gavin

State income-tax collections plummeted in the first four months of the year, a survey shows, signaling that state governments will face tight budgets and difficult decisions despite an improving economy.

Collections of state personal-income taxes between January and April fell 14%, or $14.7 billion, when compared with the same period a year earlier, according to a study to be released today by the Nelson A. Rockefeller Institute of Government, a think tank based at the State University of New York at Albany. The study is based on a survey of 41 states with broad-based personal-income taxes.

Although the data are preliminary, this period is considered a bellwether for states because they collect a large share of personal-income taxes as individuals file returns to meet April 15 deadlines. Perhaps more ominous for states, estimated tax payments—an indication of what people expect to receive in income and pay in taxes in the coming year—are down 27% from a year earlier. Nicholas W. Jenny, a senior policy analyst at the Rockefeller Institute and author of the study, says state income-tax collections typically lag behind economic rebounds, meaning state budgets take longer to recover.

"They say [state budgets] feel two years of pain for one year of recession, and there's still more to come," Mr. Jenny said. Many states managed to avoid general tax increases this year by cutting deeply into programs, but it appears they will again have to weigh whether to slice further or boost taxes when they write next year's budgets.

Among the sharpest falloffs were in taxes paid on nonwage income, such as capital gains and stock options, with many states reporting declines of 25% or more.

Hardest hit were states with big technology or financial-service sectors, industries that yielded big gains in capital-gains and stock-option income at the end of the last decade. In California, for example, January-April collections dropped nearly 29%, according to the survey, while New York, Connecticut and Massachusetts each saw personal income-tax collections fall more than 19%.

To be sure, part of the falloff is attributable to the sharp jumps in income taxes that these states collected in recent years. In fiscal 2001, which generally ended in midyear, California's personal income-tax revenues jumped 13.8%, New York's 14%, Connecticut's 12.6% and Massachusetts' 9.5%, from the year earlier, according to the Rockefeller Institute. Collections by states nationwide averaged an increase of 7.5% overall. "What went up, came down," says Mr. Jenny.

ficiency of insurance regulation. For example, if the federal government were responsible for the solvency oversight of insurers but the states retained authority over their market practices, conflicts could arise. The states would have further incentives to suppress rates, which would undermine federal solvency objectives. Alternatively, federal and state authorities could be structured so as to create checks and balances and to discipline regulators. For example, if an insurer belonged to a federal insolvency guaranty system, the administrator of that system could be authorized to enforce solvency standards that would override politically motivated actions by other regulators that would increase the insurer's financial risk.

Regulatory Expenditures

The most obvious but smallest portion of insurance regulatory costs is direct expenditure on regulation. Since 1988, the NAIC has been conducting an annual survey of state insurance departments based on their budgets, staffing, and other aspects of their activities. The data from that survey provide a basis for assessing current expenditures on insurance regulation. The more difficult task is to determine how those costs might change under an alternative federal regulatory structure. The fact that state expenditures on insurance regulation represent a minor fraction of industry revenues suggests that even a large reduction in direct regulatory expenditures would have a small effect on total industry regulatory costs. At the same time, the number of regulatory personnel and their demands on insurers can also affect insurers' compliance costs.

→ **Staffing and Budgets of State Insurance Departments.** The size of state insurance departments varies significantly depending on the size of their markets and other factors. In 1997, the number of state insurance department personnel ranged from 24 in South Dakota and Wyoming to 1,135 in California (see table 8–3).[19] The insurance departments in the four U.S. territories have smaller staffs than the states. Total full-time equivalent staff for all departments combined amounted to 10,149, in addition to 1,700 contract staff. Insurance department staff includes actuaries, financial examiners and analysts, rates and forms

analysts, market conduct examiners, consumer service personnel, attorneys, fraud investigators, and systems analysts.

For fiscal year 1999, state insurance department budgets ranged from $1.3 million in South Dakota to $127.5 million in California, with a total combined budget for all departments of approximately $797 million. The size of state insurance departments tends to vary with the volume of business that they regulate, although there is not a perfect correlation. States that have more domiciliary companies, that regulate more intensively, or that provide special services (for example, in-house liquidators) tend to have larger staffs and budgets. Public and legislative support for insurance regulation also affects department resources. The support services provided by the NAIC reduce the need for expenditures by state insurance departments.

Insurance departments draw their funding, directly or indirectly, from: fees; assessments; and premium, retaliatory, and other business and income taxes.[19] Those sources accounted for 98.7 percent of the $10 billion in revenues that states received from the industry in 1997.[20] The relative "burden" of state insurance taxes and fees as a percentage of total premiums was 1.3 percent.[21] That figure has steadily declined since 1988, when it was 1.7 percent.

Regulatory budgets represent only about 7.4 percent of revenues collected from insurers, but, presumably, those revenues support other state services from which insurers (and their policyholders) benefit. That figure has increased steadily since 1986 (when the NAIC began to track it), when it was 4.5 percent. Some insurance departments have partial or full dedicated funding that allows them to fund their operations directly from fees and assessments. Other insurance departments are funded solely from general fund appropriations, which tend to impose greater budget constraints, as those departments are forced to compete directly with other state agencies for scarce resources.

The states have significantly increased the resources devoted to insurance regulation in recent years. From fiscal year 1990 to fiscal year 1999, funding for state insurance departments increased by 80 percent (see figure 8–1). The increased funding has been used primarily to raise staffing levels, boost salaries to attract and retain more qualified staff, and improve automation to enhance staff productivity. Departments have significantly

TABLE 8–3

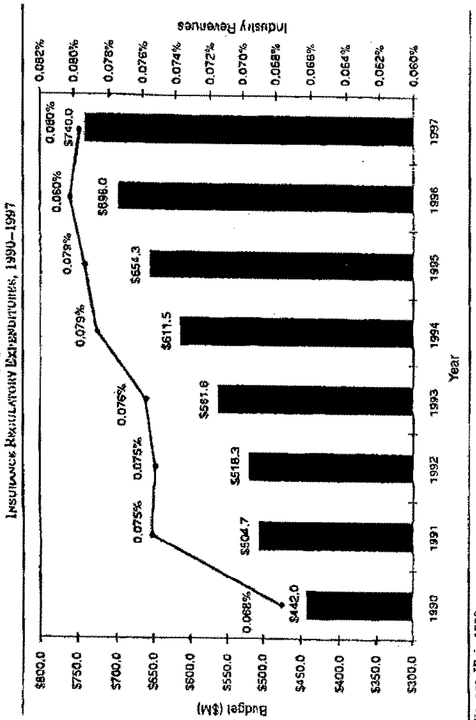
INSURANCE DEPARTMENT RESOURCES IN 1997

State	*Number of Insurers* Domestic	Licensed nondomestic	*Direct Premiums Written*	*Revenues*	*FY 1999 Budget*	*FTE Staff*
Alabama	89	1,380	$13,330,640,868	$160,700,014	$9,873,951	69.0
Alaska	10	1,088	1,572,340,407	32,483,294	4,192,400	50.0
American Samoa	N/A	N/A	2,517,242	N/A	N/A	N/A
Arizona	517	1,548	12,349,206,000	159,693,487	5,404,700	138.0
Arkansas	83	1,443	4,970,791,241	114,925,247	6,037,489	102.0
California	245	1,279	72,977,550,532	1,345,971,425	127,467,000	1,134.8
Colorado	90	1,372	13,114,189,088	117,229,739	7,900,000	95.4
Connecticut	135	1,000	13,976,728,766	222,671,522	15,564,918	164.0
Delaware	146	1,250	3,108,518,515	57,844,500	4,723,900	67.0
District of Columbia	15	1,301	3,679,096,915	47,216,450	7,000,067	62.0
Florida	477	1,858	33,292,936,170	465,904,567	64,104,297	1,043.0
Georgia	112	1,484	18,676,739,133	444,725,115	17,241,858	168.0
Guam	5	90	219,718,617	N/A	1,337,730	8.0
Hawaii	86	888	4,540,992,000	80,064,656	5,518,038	47.0
Idaho	28	1,476	2,644,685,948	52,876,200	5,101,400	64.5
Illinois	503	1,467	41,246,624,335	208,898,251	25,704,900	353.0
Indiana	204	1,666	16,289,715,880	141,171,092	4,673,237	94.0
Iowa	228	1,385	7,078,414,176	121,352,272	6,780,647	90.0
Kansas	57	1,497	5,810,540,435	140,115,654	8,004,227	164.5
Kentucky	72	1,457	8,741,582,715	155,689,965	14,051,000	174.0
Louisiana	170	1,498	10,826,176,796	189,238,852	28,227,660	261.0
Maine	32	867	2,654,010,631	47,022,101	6,074,579	72.0
Maryland	106	1,374	11,949,994,966	182,476,085	15,379,409	249.0
Massachusetts	105	1,163	27,585,578,109	26,741,423	8,422,834	163.0
Michigan	152	1,245	33,934,211,000	184,061,182	16,398,500	127.0
Minnesota	210	1,231	15,332,392,246	169,979,326	7,024,299	121.0
Mississippi	77	1,446	4,471,202,770	113,922,784	6,395,409	114.0
Missouri	309	1,529	15,066,924,869	186,132,914	12,185,653	210.0
Montana	28	1,408	1,675,033,324	37,601,561	2,094,337	43.0
Nebraska	129	1,453	4,807,803,553	54,171,918	5,929,949	92.8
Nevada	36	1,434	4,168,605,397	103,927,948	4,189,275	65.0
New Hampshire	53	800	2,757,743,796	59,897,326	3,423,415	51.0
New Jersey	112	1,085	25,136,769,913	321,298,000	33,598,000	402.0
New Mexico	22	1,521	3,232,124,928	85,157,043	3,755,300	77.0
New York	395	723	68,719,274,707	921,734,925	96,827,000	865.0
North Carolina	111	1,207	20,136,932,922	288,027,916	33,088,000	388.0
North Dakota	55	1,380	1,878,393,939	27,465,475	2,917,657	45.5
Ohio	310	1,452	30,610,882,420	384,341,389	22,122,025	243.0
Oklahoma	123	1,470	6,228,947,887	138,785,717	6,848,243	122.0
Oregon	116	1,498	8,192,702,017	89,806,213	6,389,145	98.5
Pennsylvania	350	1,318	46,203,910,291	224,105,000	19,039,000	270.0
Puerto Rico	N/A	N/A	1,685,529,391	N/A	N/A	N/A
Rhode Island	35	1,017	3,691,816,758	47,284,787	3,365,084	53.0
South Carolina	53	1,424	7,405,544,356	103,867,326	6,179,489	107.0
South Dakota	60	1,444	2,003,604,572	39,441,485	1,295,371	24.0
Tennessee	130	1,534	15,854,515,190	278,049,932	5,981,400	91.0
Texas	572	1,529	52,472,811,479	770,488,033	48,330,067	1,003.2
U.S. Virgin Islands	N/A	N/A	52,769,498	N/A	N/A	21.0
Utah	54	1,485	5,113,902,303	74,095,982	4,130,900	71.5
Vermont	329	778	1,962,380,689	31,883,710	4,407,168	49.0
Virginia	88	1,330	17,824,345,743	249,922,301	16,855,018	190.0
Washington	80	1,303	14,469,167,006	229,582,817	11,633,976	164.0
West Virginia	22	1,230	3,466,298,720	105,091,895	4,560,823	72.0
Wisconsin	342	1,476	15,600,165,174	104,186,783	7,317,200	121.7
Wyoming	5	1,211	1,026,964,622	12,100,537	1,303,843	24.0
Total	7,872		$768,503,956,703	$9,952,418,116	$796,962,242	10,148.5
Mean	151	1,304	$13,926,495,576	$195,145,473	$15,326,197	191

N/A = not available. FTE = full-time equivalent.

SOURCE: *Insurance Department Resources Report 1977* (NAIC).

FIGURE 8-1
INSURANCE REGULATORY EXPENDITURES, 1990–1997



SOURCE: Klein 1999.

enhanced their use of computers and upgraded their information systems. The increase in staff and enhanced automation has allowed regulators to substantially boost the quality and intensity of their financial oversight of insurers, as well as expand consumer protection activities. Staff and budget growth in many departments have begun to plateau as they meet their resource objectives.

Figure 8–1 also shows total regulatory expenditures as a percentage of industry premiums and investment income. We can see from that figure that regulatory expenditures have increased, but have remained a very small fraction of industry revenues (roughly 0.08 percent), over the past decade. With budgets leveling out and no new major state initiatives planned, relative regulatory expenditures are unlikely to increase in the near future unless the states were given additional responsibilities or compelled to further enhance the quality or intensity of their oversight activities.

While the NAIC data do not indicate how regulatory expenditures are divided among the various regulatory functions, that division might be inferred from the breakdown of personnel by job category. Table 8–4 shows the allocation of regulatory staff (including contract employees) by position and function. Regulators working in the financial area represent 21.9 percent of total

TABLE 8–4
ALLOCATION OF REGULATORY STAFF BY FUNCTION, 1997

Position	*Number*	*Percentage*
Financial examiners	1,198	10.1
Financial analysts	400	3.4
Liquidators	927	7.8
Company licensing	66	0.6
Rate/Form analysts	676	5.7
Market conduct examiners	425	3.6
Actuaries	293	2.5
Consumer services	1,462	12.3
Producer licensing	381	3.2
Other	6,020	50.8
Total staff	11,848	100.0

NOTE: Figures include department and contract employees.
SOURCE: *Insurance Department Resources Report 1997* (NAIC).

staff. Rates and forms analysts constitute 5.7 percent, market conduct examiners 3.6 percent, and consumer services staff 12.3 percent of total staff. If we assume that the allocation of regulatory expenditures and supervisory and support personnel follows the allocation of line personnel, financial regulation would account for close to 50 percent of total expenditures. That allocation may be significant in terms of the effect of reconfiguring state regulatory priorities or changing the institutional structure for regulation, as discussed below.

Implications of Changes in Regulatory Activities or Structures. It is conceivable that the states could reduce the number of regulatory personnel and associated expenditures by limiting their market regulatory functions to the most essential areas. Eliminating prior approval requirements for rates and forms in all lines and curtailing filing requirements for most commercial products could reduce the need for rates and forms analysts and actuaries. Indeed, many states are already moving in that direction. According to our estimates in table 8–5, a 75-percent reduction in rates and forms personnel would reduce regulatory expenditures by $75 million, or 10 percent. There would still be a need for some personnel and expenditures in that area, for monitoring and enforcement activities. Further, those changes would be unlikely to reduce the number of market conduct examiners and consumer service personnel.

It is not clear that significant reductions in financial regulatory personnel would be possible under the current state system without impairing the quality of financial oversight. Although a prudential regulatory approach might be more effective and efficient than the current prescriptive regulatory approach, it is not obvious that the latter would require fewer personnel and reduce associated expenditures.

Moving to an optional federal regulatory system could reduce expenditures in some areas, depending on the functions that were performed. Table 8–6 compares the regulatory expenditures of state insurance departments (including the NAIC) with other financial regulators. That comparison suggests that state insurance regulation is relatively costly, although some of that disparity could be caused by differences in the scope of regulatory activities as well as the regulatory jurisdictional overlap among the various agencies. In relation to the amount of assets of regulated entities, insurance regulatory expenditures are the highest at .023 percent; that percentage ranges from .011 percent to .019 percent for other financial regulatory agencies.[24]

Grace and Phillips (1999) estimate some parameters on the costs of regulating the insurance industry at the state level by examining the multiproduct cost efficiency of the state-based regulatory system. They find that the largest one-third of the states experience decreasing returns to scale in the production of regulation. The smaller states, in contrast, experience increasing returns to scale. Grace and Phillips assert that the reason the largest states experience decreasing returns to scale is because of a free-rider problem that exists between the larger and smaller states in terms of solvency regulation. If the federal government took over the solvency regulatory function, then the free-rider problem could be eliminated. Regulatory expenditures also would be reduced to the extent that state insurance departments have to duplicate some of the fixed investments in infrastructure that support solvency regulation. Grace and Phillips also find little evidence of economies of scope in state regulatory functions. Thus, a separation between federal and state regulation on a functional basis would not necessarily increase total regulatory expenditures.

Given that the states rely primarily on insurers' domiciliary states for solvency oversight, moving to a federal system would not necessarily significantly reduce the number of personnel in that area, although the need for personnel to perform secondary monitoring of nondomiciliary insurers would be eliminated. As noted above, there also might be some savings with respect to maintaining a technological infrastructure for financial regulation by housing that responsibility under one organization. The savings would be lower if a significant number of insurers remained chartered and regulated at the state level. For the sake of discussion, a 25-percent reduction in financial regulatory personnel under a federal system would imply annual savings of $100 million, representing 13 percent of total regulatory expenditures.

If the current level of market regulation were performed by a federal agency based on a uniform set of regulations, there could be a significant reduction in the number of rates-and-forms

March 2000 Poll of 1000 households by Roper Starch Worldwide
Commissioned by the Alliance of American Insurers

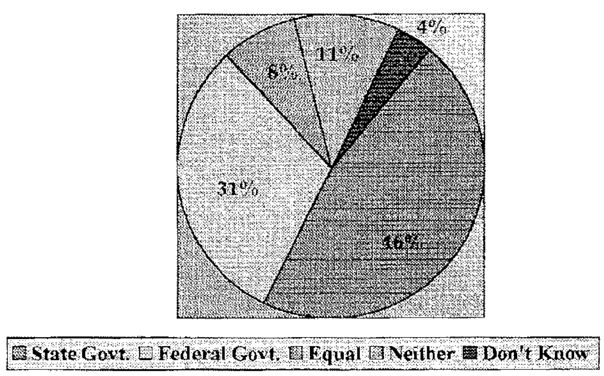
Most Effective Regulator

With multiple regulators overseeing the operations of different financial services providers, it is not surprising that questions about consolidation of regulatory functions would arise. The fear of regulatory overlap and coordination raises questions about the efficiency of the regulatory systems. Moreover, each industry has become accustomed to a regulatory culture and set of practices, and there may be some preference within industries to favor the kind of regulatory style to which companies have become accustomed. On the other hand, since regulation is a tax, insurers may also believe that the regulatory burden placed on banks and other financial services organizations is less onerous and may yield economic advantages in head to head competition. This may drive some to express a preference for competitive regulation, without considering how an alternative system would be applied to the industry itself.

The public's view of the effectiveness of regulation and regulatory agencies is important in this debate because it reflects its perception of the industry's soundness and security—items that have been identified as the most critical regulatory functions.

When asked what level of government it believed was the more effective regulator of business, a large plurality of the public responded that it believed that state government was the most effective (Chart 2). The federal government was a distant second with 31 percent of the households. This result was true for men, women, every age group and exists in all regions of the country. The only group reflecting a contrary result was black households. These respondents favored the federal government by a margin of 43 to 37 percent.

Chart 2
Most Effective Level of Government As
A Business Regulator
Source: Alliance of American Insurers



While it is apparent for many Americans that state government is viewed more favorably than the federal government as a regulator of business, their perception of regulatory agencies is less clear. To investigate this question the public was asked their opinion of the agencies that currently regulate the different financial services sectors.

Table 4
Effectiveness of Regulatory Agencies
(Percent)

	Securities and Exchange Commission (SEC)	Federal Reserve	Office of the Comptroller of the Currency (O.C.C.)	National Association of Securities Dealers (N.A.S.D.)	State Departments of Insurance
Very	15	25	11	5	9
Somewhat	26	28	20	13	30
Not Too	5	4	3	4	12
Not At All	2	2	2	2	6
Not Familiar/Don't Know	51	41	65	75	42

Source: Alliance of American Insurers

The striking, and perhaps most surprising, feature of these results is the large percentage of households who expressed ignorance regarding the effectiveness of these agencies. Even with the massive amounts of publicity given to the Federal Reserve in conjunction with recent interest rate actions, four in ten households said they had no idea about, or were not familiar with, the agency and were unwilling to render an opinion regarding the agency's effectiveness. Not unexpectedly, the Federal Reserve represents the high watermark for federal agencies. The percentages indicating a lack of familiarity with the OCC and the SEC are substantially higher, although they pale in the face of the result for the NASD. By comparison state insurance regulators show up well, although the numbers are similar to those received by the Federal Reserve.

Among those who did respond, the Federal Reserve received high marks for its regulatory effectiveness. But the Office of the Comptroller of the Currency, the primary regulator of national banks, was not only unknown by nearly two-thirds of the public it was deemed less effective than all of the other regulatory groups except the National Association of Securities Dealers by those who did respond.

As for state insurance regulators, the public seems as knowledgeable of insurance departments as they do the Federal Reserve, but its view of the effectiveness of these agencies is lower. However, state insurance regulation fared well compared with the public's view of the O.C.C., and the N.A.S.D. and was better known and comparable in effectiveness to the SEC. Based on this evidence, a compelling case for federal regulatory superiority does not seem apparent. But caution is required, however, since there have been no regulatory crises of the magnitude of the savings and loan problems of the 1980s to draw the public's attention to agency performance. What the figures suggest is households may not perceive huge differences in regulatory effectiveness or have a preference for any agency because they know so little about what these agencies do. This said, households appear to prefer regulation that is administered close to home and believe regulation at this level will be more reflective of their preferences and responsive to their needs and concerns.

Conclusion

While the history of functional regulation of financial services is short there is no evidence or reason to suggest it cannot meet the needs of markets on both sides of the transaction going forward. This study reminds us of the public's beliefs about regulation of the property-casualty industry. It is clear that the public wants regulation of the insurance industry. The perceived benefits from regulation are primarily economic to the consumer—solvent providers, stable markets and lower prices. State regulation of business, even with its diversity, is preferred as a regulator of business by a large plurality of the public. More importantly, federal regulatory agencies are not viewed as being more effective than state insurance regulation and sadly many households do not have any impression or judgement regarding the effectiveness of regulatory agencies. The public who profess to have knowledge believe there is room for improvement in all of the financial services regulatory agencies, and the agencies obviously need to do a better job in informing the public of their roles and achievements.

Despite evidence that functional regulation will work, some financial services interests are already calling for its dismantling. The centerpiece of these proposals is a shift in regulatory responsibilities for property and casualty insurers from the states to a federal or a national system. As these proposals are considered, the public's view must be considered. No matter how theoretically elegant, any system that destroys or weakens public confidence in the safety, soundness and stability of the financial services sector cannot succeed in spite of other benefits a new system might promise. Given the stakes, a rush to judgement is unwarranted. Modernization and improvements will occur; the cheese will move. How far, where and when should depend on the needs and interests of all the parties, not just a few.

BEFORE THE SUBCOMMITTEE
ON
CAPITAL MARKETS, INSURANCE AND
GOVERNMENT-SPONSORED
ENTERPRISES

UNITED STATES HOUSE OF
REPRESENTATIVES

TESTIMONY OF WAYNE F. WHITE

PRESIDENT & CHAIRMAN
OF
HOME MUTUAL FIRE INSURANCE
COMPANY
CONWAY, ARKANSAS

TUESDAY, JUNE 4, 2002

ON BEHALF OF

THE NATIONAL ASSOCIATION OF
MUTUAL INSURANCE COMPANIES
NAMIC

TESTIMONY OF
WAYNE F.WHITE
PRESIDENT & CHAIRMAN OF
HOME MUTUAL FIRE INSURANCE COMPANY

ON BEHALF OF
THE NATIONAL ASSOCIATION OF MUTUAL INSURANCE COMPANIES

ON INSURANCE REGULATION AND COMPETITION FOR THE 21ST CENTURY

BEFORE THE
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND
GOVERNMENT-SPONSORED ENTERPRISES
UNITED STATES HOUSE OF REPRESENTATIVES

JUNE 4, 2002

Chairman Baker, and members of the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises of the House Committee on Financial Services, my name is Wayne White. I am President and Chairman of Home Mutual Fire Insurance Company in Conway, Arkansas.

Today, I am here as a representative of the National Association of Mutual Insurance Companies (NAMIC). It is an honor to have this opportunity today to address you at this hearing on "Insurance Regulation and Competition for the 21st Century."

I have been asked to discuss the history of state insurance regulation, including the evolution of the National Association of Insurance Commissioners (NAIC); the role of advisory organizations like the Insurance Services Office (ISO) in creating standard forms and collecting loss control data; the effect that rating agencies like A.M. Best and Standard & Poor's have on the insurance industry; and, finally, to provide you with NAMIC's perspective on the future of insurance regulation.

As you may know, the first insurance company formed in the American colonies was actually a mutual: The Philadelphia Contributionship for the Insurance of Houses from Loss by Fire. It was created in 1752 after Benjamin Franklin and a group of prominent Philadelphia citizens came together to help insure their properties from fire loss.

In those early days before America declared its Independence from British rule, most insurance companies followed the Contributionship model; that is, groups of neighbors typically formed entities to help each other avoid the certain financial ruin that would befall them if their properties were destroyed by fire.

While we honor our roots, today's mutual industry also has a clear vision of the future. I come here today to speak in defense of the proposition that a reformed system of state insurance regulation is superior to an unproven system of federal regulation.

NAMIC's position is representative of a dynamic cross section of the property/casualty (p/c) industry. We are the nation's largest p/c trade association with 1,300 members that underwrite 40 percent of the p/c insurance premium written in the United States. NAMIC's membership includes 5 of the 10 largest p/c carriers, every size regional and national insurer and hundreds of farm mutual insurance companies.

Because of our position, NAMIC welcomes this series of hearings. At their conclusion, we believe you and your colleagues will reach the same judgment as our member companies: while insurance regulation cries out for reform, industry governance is best based in the states.

Calls for reform of the state insurance regulatory system have been heard for years but little substantive reform, other than the NAIC financial accreditation program, has occurred. Frustrations have grown as the marketplace becomes more competitive, and more global. Complicating matters further is that the NAIC is often --wrongly in our view -- held to account for implementation of sweeping reform.

THE NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

By the middle of the 19th century, several insurance entities, like the Philadelphia Contributionship, had expanded beyond their original neighborhoods or cities and had begun to insure residents in other parts of their states. State legislators took notice of this development and believed that a more formal system of insurance regulation was needed, the first of which was established in New Hampshire in 1851.

In May 1871, insurance regulators from around the country convened the first meeting of the National Convention of Insurance Commissioners (later the NAIC). Regulators adopted the following objectives to help each other regulate companies doing business in more than one state:

- To promote uniformity in legislation affecting insurance;
- To encourage uniformity in departmental rulings under the insurance laws of the several states;
- To disseminate information of value to insurance supervisory officials in the performance of their duties;
- To establish ways and means of fully protecting the interest of insurance policyholders of the various states; and
- To preserve to the several states, the regulation of the business of insurance.

Indeed, the early work of the NAIC was focused on achievement of uniformity in the regulation of national companies. By 1981, the NAIC's purpose was streamlined as follows:

- Maintenance and improvement of state regulation of insurance in a responsive and efficient manner;
- Reliability of the insurance institution as to financial solidity and guarantee against loss; and
- Fair, just and equitable treatment of policyholders and claimants.

While states continue to regulate the business of insurance today, the federal government has had an abiding interest over the years in how well the industry has been regulated.

The first Supreme Court of the United States decision on state versus federal power to regulate insurance was Paul v. Virginia (1869). The Court held that delivery of an insurance policy in Virginia issued by a New York company was not interstate commerce. A narrow definition of "commerce" was employed by the Court. As a mere contract rather than a physical good or commodity, Congress was not empowered to regulate it.

Around the time of the Paul case, segments of the industry, responding to fierce rate and commission competition that had resulted in enough failures to damage public confidence, organized themselves into rating bureaus to establish and maintain adequate rates, control excessive commissions and standardize policy forms. These industry-run "cartels" operated through the mid-1940's without disruption.

In 1944, the Supreme Court redefined insurance as interstate commerce, triggering passage of the McCarran-Ferguson Act by Congress the following year. Under McCarran, states can preempt federal anti-trust laws by regulating the business of insurance. The industry and the NAIC were given three years to devise a regulatory framework that could be put into effect across the country to halt enforcement of federal anti-trust and discrimination acts.

Toward that end, the NAIC developed model acts and regulations related to insurance rates and policy form language that were quickly enacted by the states. Industry bureaus, at issue when Paul was overturned, were given new life. Although the new state laws typically subjected bureau rates to regulator endorsement, companies were either required or at least strongly encouraged to employ bureau-established rates. This set of circumstances gave birth to the present regime of prior approval for property-casualty products now operational in more than half the states, against which many of the arguments in favor of speed to market reform are based.

In the late 1980s and early 1990s the House Energy and Commerce Committee held a series of hearings, not unlike what this Subcommittee is doing today, to question state regulators in the wake of some highly publicized insurer insolvencies.

The House Energy and Commerce Committee's persistence in challenging regulators was instrumental in the NAIC adopting its Financial Regulation Standards and Accreditation Program in 1989. The program consisted of a set of financial regulation standards for state insurance departments, which identified model laws and regulations, and regulatory, personnel and organizational processes and procedures necessary for effective solvency regulation.

Nearly all the states, with the help of their legislatures, subsequently adopted the accreditation standards, but this has not stopped Congress and others from continuing to ask probing questions about the continued viability of the program. As recent as August 2001, a report prepared by the General Accounting Office outlined "gaps and weaknesses" in the accreditation program in response to the Martin Frankel fraud scandal. This, in turn, has caused the NAIC to re-evaluate certain aspects of its accreditation standards.

Clearly, this type of "oversight" of state insurance regulation seems appropriate for Congress to continue to pursue. It is also important here to mention another "role" that Congress has played with respect to state insurance regulation in the past decade. In 1992, Congress enacted legislation that had the effect of standardizing the Medicare supplemental insurance policies. While Congress mandated this requirement, it was left to the NAIC and the states to "design" the standardized forms and to implement their use in each state.

While this particular piece of legislation appears to have worked well in protecting citizens from purchasing unnecessary multiple Medigap policies, it is not yet clear to us whether this approach would work for other lines of insurance or in possibly bringing more uniformity to certain state regulatory functions.

The Gramm-Leach-Bliley Financial Services Modernization Act (GLBA) contained at least two provisions directly affecting state insurance regulation. The first called on state regulators to develop a better system of licensing out-of-state insurance producers, or face a Congressionally mandated entity to perform that function.

Regulators responded with a uniform producer licensing model act and two years' worth of effort enacting it in most state legislatures. As of May 2002, 45 states have passed the model act or other licensing laws to satisfy the reciprocity licensing mandates of GLBA. Five more state legislatures are considering the model act this year. At the same time, regulators have begun to coalesce behind a plan to develop a national database for processing producer applications.

While improvements are still needed, it does appear that regulators have met your mandate and are creating an improved producer licensing process.

The other GLBA provision required insurers to protect the nonpublic personal information of their policyholders. Forty-nine states and the District of Columbia have met the GLBA privacy standards, largely based on the NAIC privacy model. Discussion is now focused on developing uniform interpretations of the law in each state.

Taking the intent of GLBA one step farther, regulators agreed to a "Statement of Intent" in March 2000 outlining their desire to change the organizational structure of insurance regulation to better address the rapidly evolving changes to the financial services industry.

This brief review of the NAIC's origins and its objectives over the years can only lead to the conclusion that the NAIC is the protector of the principles of insurance regulation in general and state regulation in particular and as such it should be the source of comprehensive reform.

However, in our judgment this is incongruent. In describing its own work, the NAIC has said that regulators have long realized that diversity and experimentation are strengths of the state system, but they also recognize that the basic legislative structure of insurance regulation requires some degree of uniformity throughout the states. This inherent tension between sovereignty and uniformity in the context of a voluntary organization of mostly appointed state officials with no authority to enact the models they write has produced both large expectations and large disappointments.

While one must be cautious not to over-evaluate the NAIC's efforts, it is an obvious question to ask how they have done. Regulators have met the requirements imposed on them by GLBA. They also have spent considerable time in the past two years discussing how to make certain of their processes and procedures more uniform. For example, all jurisdictions now use a uniform licensing application for companies, and a new project is underway to determine what requirements are necessary and can be made uniform for insurers after a merger or acquisition.

As my home state commissioner Mike Pickens likes to say, "the NAIC has a good story to tell," and they will be here to tell it themselves as part of these hearings.

NAMIC is encouraged by the NAIC's post-GLBA performance with respect to the mandated tasks as well as the Statement of Intent initiative. The NAIC also deserves recognition for focusing attention on key marketplace improvements such as speed-to-market and market conduct for which NAMIC member-companies are asking. Out of necessity, much of their work concerns the procedural or functional aspects of regulation. Unfortunately, by themselves, better procedures do not satisfy the deeper needs of the industry.

While individual state regulators can recommend standards for reform and raise the profile of important market reform issues, they cannot act alone. Simply put: the NAIC cannot be expected to do what it is not empowered to do, that which is the most pressing task for all of us concerned about the future of the insurance industry: enactment of fundamental public policy reform.

In the final analysis, before Congress intercedes, state legislative action must be the focus of modernization initiatives. There are important and effective national organizations prepared to lead reform efforts in the states.

ROLE OF NATIONAL LEGISLATIVE ORGANIZATIONS

NCOIL. The National Council of Insurance Legislators was formed in 1969 to help legislators make informed decisions on insurance issues affecting their constituents and to oppose any encroachments of state authority in regulating insurance.

NCOIL members collectively represent residents in states where 90 percent of insurance premium is written each year. In addition to conducting annual meetings/seminars for its members, NCOIL has been instrumental over the years in developing its own set of model laws that have been enacted in several states. These models have addressed issues such as financial information privacy, mental health parity, life settlements, long-term care tax credits, federal choice no-fault, commercial lines deregulation and property/casualty domestic violence.

NCOIL was the first organization of state officials to support establishment of a federal backstop to cover terrorism, sending a letter in support of such an initiative to House leadership in October 2001. The leadership of NCOIL also has testified at several Congressional hearings in opposition to initiatives that would have created a dual system of insurance regulation, in opposition to Congressional initiatives that would have usurped the existing authority of states to regulate insurance rates, and on the viability of having an interstate compact to govern key aspects of insurance regulation.

ALEC. The American Legislative Exchange Council was founded in 1973 by a small group of bipartisan state legislators with a common commitment to the Jeffersonian principles of individual liberty, limited government, federalism, and free markets. Today, ALEC has grown to become the nation's largest bipartisan individual membership organization of state legislators, with more than 2,400 members in 50 states.

ALEC remains committed to preserving the state regulation of insurance and has developed its model Property/Casualty Insurance Modernization Act to facilitate the replacement of outmoded, inefficient insurance regulations with market-based reforms. In addition, ALEC has developed a special project, national in scope, designed to educate state lawmakers about the importance of making insurance regulatory changes that are less intrusive and more uniform in nature, which is one of the primary goals of those clamoring for federal preemption. ALEC has even formed a National Insurance Modernization Working Group to help facilitate this project and to discuss other cutting edge policy ideas related to the business of insurance.

One of the most exciting aspects of ALEC's involvement with this issue is its extraordinary record of success in affecting public policy changes in other areas. ALEC, for example, is the preeminent force for state level tort reform efforts facilitated through ALEC's Disorder in the Court Project. ALEC legislators introduced model tort reform legislation in more than 20 states alone last year. Members are also responsible for passing model pension reform legislation in 13 states over the past two years, a monumental success. This leadership is likely to continue. More than 100 ALEC members hold senior leadership positions in their state legislatures, while hundreds more hold important committee leadership positions.

NCSL. The largest state legislative organization is the National Conference of State Legislatures, formed in 1975.

Recently, the organization created an Executive Committee Task Force to Streamline and Simplify Insurance Regulation. The Task Force includes leaders from NCOIL, members of ALEC and enjoys the support of the NAIC.

While NCSL has no more power to bind than does the NAIC, there is a fundamental difference in authority. The primary component of NCSL's mission is to advise Congress and the Administration as to the effect of federal action on the states. Its members are elected officeholders with obvious influence over the outcome of legislative proposals in the states.

The work of this particular Task Force is especially distinguished because it will develop a set of recommendations to streamline state insurance regulation and ask state legislators to consider them. One recommendation may be an interstate compact that would facilitate the approval of annuity, life insurance and disability income products by a single entity for use in all insurance jurisdictions as well as various speed to market proposals that affect the property-casualty industry. For the NCSL to depart from its federal advisory function to make specific state proposals is an extraordinary step.

NCSL has only suggested model legislation for state consideration three other times. The first time was in 1990 when an NCSL Executive Committee Task Force on Insurance endorsed the first 11 model bills dealing with the NAIC accreditation process, created to forestall the threat of federal solvency regulation. Within two years, 48 states had enacted the models that would permit their accreditation.

A decade later, the NCSL Executive Committee Task Force on State and Local Taxation of Telecommunications and Electronic Commerce drafted model legislation to bring together state revenue department officials to discuss ways to streamline sales and use tax collections. By the end of 2000, 32 states, either through legislative enactment or an executive order of the governor, had officially joined what is now called the Streamline Sales Tax Project.

Finally, the same E-Commerce Task Force drafted and endorsed model legislation in 2001 to help policymakers finalize the terms of a streamlined sales tax interstate agreement. Last year, 22 states enacted this second model act on sales tax reform and presently another 13 states are considering the model bill during this year's legislative session.

To round out the most important elements of the insurance regulatory landscape, I want to touch on rating bureaus and rating organizations.

RATING BUREAUS/ADVISORY ORGANIZATIONS

The property-casualty insurance industry today is intensely competitive and fragmented, particularly in the commercial insurance marketplace with no single insurer having more than a 5% market share. Not only do insurers compete in the way they package and price their products, but they also compete in the way they distribute and service them. Within the industry, today's modern "advisory organizations" provide insurers with critical insurance information that promotes competition between all insurers and adds economies of scale to those functions vital to each individual insurer. Access to a broad base of reliable information and standardized coverage parts that comply with state requirements permits any insurer to enter new insurance markets and compete in existing ones that might not otherwise be possible if individual insurers had to rely solely on their own, internal information.

The evolution of today's advisory organizations dates back to the early to middle 1800's when fire insurers formed compacts (otherwise known as rating bureaus) to establish and maintain adequate rates and to standardize policy forms. These bureaus sought to bring discipline to an industry known for overly excessive competition and rate and commission wars which resulted in many insurance company failures and erosion of public confidence in the insurance industry. Although initially local and regional in nature, rating bureaus ultimately began to consolidate on a national level to eliminate duplication of resources and to take advantage of expense savings associated with economies of scale. By the mid-20th century a number of rating bureaus had evolved into several national entities, all serving multiple lines of business.

In 1968, the National Bureau of Casualty Underwriters and the National Association of Automobile Underwriters merged into the Insurance Rating Board. In 1971, many of the functions of the Insurance Rating Board, the Multi-Line Insurance Rating Bureau, and the Inland Marine Insurance Bureaus were undertaken by a new organization, the Insurance Services Office (ISO). Although ISO is the largest advisory organization, there are other organizations that provide similar services to property casualty insurers. These include the Surety Association of America (surety), the National Council on Compensation Insurance (workers compensation), and the American Association of Insurance Services (property-casualty lines other than workers compensation and commercial fire).

Today's advisory organizations operate very differently from the bureaus in the early 1900's. ISO's charter specifically states that all ISO information and services are purely advisory -- that is, insurers select among any of ISO's services and use them as they choose to. ISO no longer develops advisory rates and instead provides "advisory prospective loss costs," which do not include any provisions for insurer profit and expenses. Today, insurers that purchase advisory organization information may or may not use any of that information, and each company makes its own independent decisions based on individual company circumstances. Rate setting is now a matter between individual insurers and regulators.

ISO provides statistical and actuarial information and analyses, policy forms, information about specific locations, fraud-identification tools, data processing and related services for a broad spectrum of commercial and personal lines of insurance. (For example, ISO develops advisory policy forms, in compliance with the coverage requirements of each state, to address diverse coverage needs). ISO is regulated as an advisory organization and performs its various functions in each of the fifty states, D.C., Puerto Rico, Guam and the Virgin Islands. ISO information is available to any property-casualty insurer. All services are advisory in nature and insurers are free to use, modify or not use ISO information as they determine their own strategies in a highly competitive insurance marketplace. In the United States and around the world, ISO serves insurers, reinsurers, agents, brokers, self-insureds, risk managers, and insurance regulators and other government agencies.

The pro-competitive benefits of advisory organization products and services are well documented and include:

<u>Accurate projections of future claims payments</u>: Pricing insurance is difficult. Unlike most businesses, insurers can't set a price based on known costs for production and distribution. When pricing a policy, an insurer needs to project the costs of future insurance claims by examining historical data. This method is reliable only when the insurer uses a sufficient amount of accurate data. Advisory organization actuaries are highly trained to compile, edit for quality, process and combine compatible data from many companies into statistically credible pooled data bases accessible by any insurer which, along with its own data and other information, enables an insurer to independently determine its own prices and competitive strategies.

<u>Economies of scale</u>: For many states and lines of insurance, if individual insurers had to replicate the pooled database, actuarial analyses, professional staff and data processing provided by

advisory organizations, the costs would be so great that a number of insurers could be forced out of many markets. Those insurers that remained would pay for any resulting insolvencies, as well as incur higher expenses for replicating advisory organization materials, thereby making the cost of insurance more expensive.

Ease of market entry: Access to advisory organization products and services enables insurers of all sizes to more easily enter product lines or geographic markets they might not otherwise consider worth the risk or the start up costs. An example of this effect recently occurred in Texas, where the Governor noted that the availability of an ISO policy form would enable more insurers to offer affordable homeowners insurance.

Availability of a credible aggregate industry database: Advisory organization's data compilations increase data quality for both insurers and regulators and facilitate research and development of new products and innovations to existing products. ISO submits summaries of this information to insurance regulators—as required by law—to help the regulators evaluate the price of insurance in each state.

RATING ORGANIZATIONS

Another important service to the insurance industry is the work provided by the handful of companies that produce independent ratings for insurance companies. These analyses serve to provide bankers and investors with invaluable information upon which they can make informed decisions. The rating organizations also act as an "adjunct" regulator by providing insurance regulators with another perspective on companies licensed in their jurisdictions.

Among the oldest of these service companies is A.M. Best, which was founded in 1899. Other ratings firms are Standard & Poors Corporation, Fitch, Weiss, Demotech and Moody's.

Although ratings firms may seek and consider regulators' criticisms and orders concerning market practices, ratings firms' fundamental concern lays in the claims-paying ability of the entity rated. Indeed, whether or not it is the first thought they may have in securing insurance protection, policyholders' fundamental concern—certainly the one foremost at the time of any loss—is the claims-paying ability of their insurance carrier. They want the promise to be kept.

Any rational process of decision-making in purchase of goods and services involves the prospective purchaser's perceptions of price and quality. In this context, i.e. the purchase of a promise, policyholders, lenders, and others are concerned with the quality of the promise made by the insurance entity. Although there may be qualitative details with respect to the contract for that promise, there is, finally, the matter of whether the insurance company now possesses resources to timely execute its promise and whether it will continue to be able to pay to policyholders its promises.

To understand the resources required for, and to systematically rate the claims-paying ability of an insurance entity is, without question, complex. Policyholders, lenders, and those whose business is otherwise affected by indemnification of policyholders from loss, perceive value in the guidance of those who credibly provide simplification of what is complex. Ratings firms offer such value. Their analyses of the claims-paying ability of insurance entities are used in decisions where the quality of the promise is of weight.

Insurance ratings firms are in a position of extraordinary leverage because of their input into the purchase of hundreds of billions of dollars of insurance protection. Ratings firms thereby, fairly or otherwise, will affect insurers' behavior to the extent insurers' understand their criteria for rating claims-paying ability. Ratings firms will also, through that extraordinary leverage and according to the rating rendered, affect the fortunes of insurance entities. A positive rating may be a factor toward a company's growth and prosperity. Somewhat more surely, a negative rating published by a credible ratings firm will diminish the going-concern prospects of an insurance entity.

With that overview of the function of ratings firms and the potency of their published analyses, it is also important to understand their relationship to the states' structures for the regulation of the business of insurance.

A brief sketch of the relationship is that ratings firms are independent of state regulation with respect to their judgments of the claims-paying ability of an insurance entity. Yet the relationship is more complex than pure independence and is notable for ratings firms' use of information generated from the states' regulatory regime. States' grant of the privilege to conduct insurance business is accompanied by extensive and highly formalized requirements for accumulation and delivery of information on the financial results and status of the insurance entity—in addition to much additional detail on other aspects of the business. Ratings firms are beneficiaries of these regulatory requirements: They understand and intensively use this regulatory information generated as a result of states' regulatory requirements.

Please understand that the states, using the NAIC for common development of accounting principles, prescribe with great rigor how and when insurance entities will account for all transactions undertaken. Although many additional non-accounting rules for financial regulation are also prescribed, the essence of this solvency regulation is called statutory accounting, which gives greater emphasis to conservatism than generally accepted accounting principles (which will also be used for reporting to investors by those companies subject to SEC regulation). Again, with respect to ratings firms' relationship to state regulation, statutory accounting prescribed by the states, is the raw material for much of the business of ratings.

Do the states rate insurance entities in their domicile? In effect they do, but it is a more confidential process and one very much directed toward identifying and supervising weakened companies—rather than placing companies on a comprehensive scale of relative claims-paying ability. Use of companies' risk-based capital measures, sets of financial ratios, and other means for judging financial strength are fundamental tools—some of them conducted for states by the NAIC—for identification of those companies that become weak with respect to their ability to pay claims.

Do regulators use ratings developed by ratings firms? We are aware that they are sometimes used to identify weak companies or, more likely, to affirm state examiners' judgments as to companies' viability. It would be accurate to say, however, that state- and NAIC-developed analyses are by far the more important in states' procedures and legal process affecting weakened insurance entities.

Why do ratings firms exist alongside the state regulatory apparatus when states have power to prescribe content and period of reporting? Ratings firms obviously publish for their specific market of policyholders, lenders, and others concerned with insurance entities' claims-paying ability. States do not. Further, ratings firms publish annually and update still more frequently, thereby accommodating users need for current information. States conduct financial examinations on a cycle of three to five years, occasionally accelerating that schedule for companies perceived to be weakening.

In that business of providing information for those concerned with insurance entities' claims-paying ability, ratings firms digest large amounts of specialized and complex data on insurance entities and present it to readers in a form more easily used by those with interest. In short, users of such information pay for value added by ratings firms' efforts to gather, analyze, and interpret complex data.

We should say additionally—and this relates to concerns of NAMIC—that users are paying additionally for somewhat more subjective analysis by ratings firms of subject companies' management. This more qualitative element of ratings includes the ratings firm analyst's view of the capability of the subject company's management to cope with shocks and swings in the market for the company's products and how adaptable and aggressive management may be in that context. This more subjective dimension of the ratings process, NAMIC and others with concern have suggested, is that continuity through time, and continuity from analyst to analyst, may not always be present. Indeed, even with respect to more objective financial data, consistency and continuity may be less than perfect as time passes and analysts change.

It is not a revelation, then, that companies' experience with the rating process may include some perceptions of unfairness or neglect of the subject company's having historically met all valid promises. We admit that the essence of the relationship between a ratings firm and a rated company has an inherent adverse dimension. Companies may have wholly tenable reasons for disagreement with a tentative rating; the company must then muster its best arguments for revision.

Ratings firms are part of the insurance market. Buyers seek advice from those who can gather and interpret complex data on carriers' ability to execute their crucial function of paying claims. Ratings firms purport to provide that advice; they will not always be accurate; we do know they will continue to be part of the marketplace.

THE ROAD TO REFORM FROM THE NAMIC PERSPECTIVE

NAMIC recently released a public policy paper articulating our argument against federal regulation of insurance. Entitled ***Regulation of Property/Casualty Insurance: The Road to Reform,*** it is the culmination of years of member study. Our member companies began their consideration with an open mind, but as work progressed it became clear that the best option for consumers and the insurance industry is to reform the state system rather than running to Congress for a solution that promises to be worse than the original problem.

As you know, the insurance industry is at a crossroads. Many in our industry already have chosen the path of reform that runs through Washington. They believe the state system of regulation is irreparably broken and only can be fixed by Congressional action. Others take a wait and see approach to reforming the state system. Indeed, they are engaging in efforts of reform, but with one eye on the clock, almost waiting to jump on the bandwagon making the most progress.

Missing from this debate is the point of view that a federal regulator, or even a dual charter, is not in the best interest of the industry or consumers. It is this point I wish to also make today.

Flaws in The Enactment and Implementation of a Federal Solution

In developing our public policy paper, NAMIC identified a series of "flaws" in a federal solution to insurance regulation. They include:

1. **We oppose federal action because it is often used to enact social regulation**. Under a federal system, insurance is likely to be treated as another "government entitlement" with all the trappings associated with that term. This would cause serious erosion to the basic risk sharing principles upon which the industry is built and I do not believe is the intention of this committee.

2. **Asking Congress to intercede is fraught with danger for consumers and industry.** Proponents of federal regulation may design their idea of "a perfect system," but they can neither anticipate nor prevent the imposition of social regulation in exchange for the new regulatory structure. In our judgment, the chances of the "perfect system" going from draft legislation into law are almost nil.

3. **A federal or dual charter not only would not reduce regulation, it would add regulatory layers and complexity to the current system**. It is by no means certain that a new federal regulator would be the "single" regulator for even the largest property/casualty insurance companies. Dual regulation would produce an unfair environment for the thousands of smaller companies, and create regulatory competition that often produces poor policy in financial institution regulation.

4. **Costs and bureaucracy will increase under a federal framework.** Will a federal charter reduce regulatory costs that are indirectly paid by consumers and/or taxpayers, and will it bring about less bureaucracy for companies choosing this option? There is no evidence that a federal insurance regulator is going to depart from the tradition of creating an expensive and inefficient government program. In addition, each state has its own unique tort laws that significantly affect insurance. Federally licensed insurers would have to tailor products to accommodate each state's tort laws. Not doing so will significantly hamper gaining efficiencies from a federal system.

The cost to consumers will inevitably rise as well. Currently, states derive significant income from premium taxes, which exceed the cost of regulation. The cost of a new layer of federal regulation must be accounted for somehow. The necessary funds must either come directly from the federal budget, or from fees assessed to insurers. Since taxes and fees must be passed on to consumers, they will have to pay for two regulatory systems, unless the states forego premium tax revenue. Considering the current condition of most state budgets, it is hard to imagine that they would do so voluntarily.

5. **When the single national regulator makes a mistake, it has significant economy-wide consequences**. When a state regulator makes a mistake, the damage is localized and can be more easily "fixed." In other words, what if Congress gets it wrong? Industry proponents argue that Congressional action could be bring a system resembling that found in Illinois to the entire country. But what if the system created looks more like highly regulated states? The economic fallout from a strict national regulatory climate would be crippling, and the accountability would be at Congress' door.

6. **The time for further change has not arrived**. The new balance necessitated by GLBA is still evolving. It has shown great promise, but requires more time to mature fully. Unlike 1999 when GLBA passed, there is no major impetus, such as convergence of the financial services industry, to further change the balance between federal and state regulation. In times past, momentous change has been the consequence of significant needs or events. No such need exists today. Change without need could destabilize a system that has worked well throughout our nation's history.

State Regulation is More Pro-Consumer

From a consumer's perspective, the state system of regulation has performed admirably. It has proven to be adaptable, accessible, and relatively efficient, with rare insolvencies and no taxpayer bailouts. Proposals for federal and dual charters offer few advantages for consumers, and consumer interests are rarely cited as reasons for changing from the state system.

Federal regulation is no better than state regulation in addressing market failures or consumer interests. Regulated industries of all types have had failures at both regulatory levels. Neither can claim immunity from market failure. Additionally, claims that consumers are well served by federal bureaucracies seem dubious.

The clear advantage to consumers in the state system is accessibility. It is easier to deal with regulators in every state than having to contact a regional federal office to intervene in disputes.

A Reformed System of State Insurance Regulation is Superior

Changes must be made to create a reformed, rationalized and consistent system that will benefit both consumers and industry. NAMIC is working with national legislative organizations on four specific areas for state reform:

RATE REGULATION

States should eliminate the approval process for pricing insurance products. The NAMIC Board of Directors has endorsed the NCOIL Property/Casualty Modernization Act approved in 2001. The model lays out a "use and file" regime for personal lines in competitive markets and a "no file" standard for commercial lines. There is unanimous support among the industry trades for this language.

Still, this is a potentially controversial issue among some state legislators. However, rate modernization not only is not radical, it is not new. Two brief examples speak to its success as public policy:

- In 1969, the **Illinois** legislature repealed outright the prior approval law that was put in place following passage of McCarran-Ferguson in 1945. Property/casualty rates in Illinois remain unregulated today. Several vital signs demonstrate that this policy works well. Today, consumers enjoy stable rates, ranking in the middle of all states in average personal expenditures because the Illinois market attracts the largest share of all private passenger auto and homeowner insurers in the nation. Low residual markets indicate affordability and availability. These positive signs are all the more remarkable when you consider that Illinois includes the third largest urban area in the United States, and two-thirds of the state's residents live in the Chicago area. With over three decades of success and no legislative proposals to reinstitute regulation, there can be no argument that this structure is well tested and beneficial to everyone involved.

- The demonstrably negative impact of prior approval on **South Carolina**'s state auto insurance market prompted the Legislature to act in 1999. Only 78 companies offered policies in the state in 1996 and over 40 percent of all insured drivers were in the assigned risk pool. With the elimination of prior approval in favor of a flex rating system, 105 new companies are in the market, rates are lower and residual market participants, once numbering over a million, have declined to 58,000.

Finally, even **New Jersey**, one of the most restrictively regulated states in the nation, is in the process of a public policy overhaul. Noting that consumers pay the highest auto premiums in the country and that more than 20 insurers have left the state during the 1990s, Governor McGreevy has agreed to support language in his legislature very similar to the NCOIL model.

The NAIC has endorsed an interstate compact that would facilitate the approval of annuity, life insurance and disability income products by a single entity for use in all insurance jurisdictions. The compact will be the principal topic of discussion at the NCSL Task Force meeting that convenes this Friday in Philadelphia.

As has been often and loudly stated, the product approval process is especially challenging for the life industry because of direct competition with banks in certain financial services. NAMIC agrees that the life industry and its consumers would be well served by a streamlined regulatory process. Efforts to create a more competitive marketplace for insurers and consumers alike must not begin and end on the life side of the equation. I cannot conceive that many p-c insurers would be supportive of that approach.

As Congress continues its oversight, we strongly encourage you to look for progress in achieving speed to market for both life and property-casualty products.

MARKET SURVEILLANCE

States vary widely in how they staff and approach their market surveillance activities. A few states, for example, regularly schedule market conduct exams, regardless of whether an insurer has problems or not. The open-ended costs of these exams (salaries, meals and lodging) are charged to the company under examination. A lack of uniformity and coordination among states in performing exams often results in duplicative and costly processes, especially for multi-state insurers, who are most likely to be targeted for review.

As state insurance departments spend less time on "front end" regulation (i.e. prior approval), states need to adopt a market regulation program that relies on analysis of existing and available market data to reveal performance deviations rather than largely open-ended market conduct examinations relied upon today. With this approach, regulators can focus their limited resources on companies that fall outside a predetermined set of standards developed from data analysis. Any new market regulation process must be proportional, allowing insurers to mitigate complaints or market inconsistencies before being subjected to more severe actions like a market conduct exam, administrative penalty or fine.

SOLVENCY MONITORING

State regulators have adopted several solvency tools over the past decade to strengthen oversight of the insurance industry. While the industry has supported improvements in solvency monitoring, there remains a high degree of variation among states in how financial exams are conducted. NAMIC recently helped to produce an industry white paper that identifies three primary recommendations to facilitate discussion of the examination system by all stakeholders. Recommendations under consideration by the NAIC center on controlling expenses, integration of private CPA auditor work and risk-oriented financial reporting.

COMPANY LICENSING

States, working through the NAIC, have made some progress in the past few years in bringing more uniformity to the company licensing process. One outcome is the Uniform Certificate of Authority Application (UCAA), which is now used in all insurance jurisdictions. The states should now consider draft language so future amendments to the UCAA can be adopted without seeking legislative approval each time. However, the key to more uniformity of this process is ensuring that state deviations are reduced or eliminated.

NAMIC joins with our colleagues in asking for fundamental reform of insurance regulation. We disagree with some on the method to bring this about. State insurance regulation can be reformed through emphasis on state legislatures, not Congress, but it will take some big thinking and outstanding leadership to bring this about.

The areas for reform have been defined. Now it is up to the states to enact changes in public policy that will make the difference. We urge you to continue your efforts to assure that change takes place in the states. Significant activity is already underway. As it has in the past, your interest alone will prompt a redoubled resolve on the part of state legislatures. We believe this pressure, given time, will bear fruit.

TESTIMONY OF VERMONT STATE REPRESENTATIVE MARK YOUNG, NATIONAL CONFERENCE OF INSURANCE LEGISLATORS (NCOIL) VICE CHAIR OF THE STATE-FEDERAL RELATIONS COMMITTEE

BEFORE THE U.S. HOUSE OF REPRESENTATIVES FINANCIAL SERVICES COMMITTEE CAPITAL MARKETS, INSURANCE AND GOVERNMENT SPONSORED ENTERPRISES SUBCOMMITTEE

2128 RAYBURN HOUSE OFFICE BUILDING, WASHINGTON, D.C.

JUNE 4, 2002

2:00 P.M.

Chairman Baker, Members of the Subcommittee, thank you for inviting the National Conference of Insurance Legislators (NCOIL) to testify before you today. I am Representative Mark Young. It is my privilege to represent residents of Addison and Rutland counties in the Vermont legislature. It is my further privilege to serve as Vice Chair of the NCOIL State-Federal Relations Committee. NCOIL is an organization of state legislators whose main public policy concern is insurance and insurance regulation. State legislators active in NCOIL chair or are active members of the Insurance Committees in their respective legislative houses across the country.

In response to the Subcommittee's request, my testimony will focus on state guaranty funds and residual markets. In further response to your request, my testimony will report briefly on financial modernization and the progress state legislatures and insurance commissioners are making toward that end.

NCOIL welcomes your request for this testimony on state insurance guaranty funds. The guaranty funds provide an example of how well state insurance regulation can work. In fact, it may be worth noting here that none of the present day critics of state insurance regulation have identified the state guaranty fund system as being inefficient, ineffective or in need of any major reform.

I will first provide some basics on state guaranty funds and their purpose. Then I will move on to discuss how the funds have fulfilled that purpose. I also will provide some observation with regard to needed improvements.

BASICS OF STATE GUARANTY FUNDS

In each state, a guaranty fund consists of the insurers doing business in that state in the line of insurance covered by the fund.

The purpose of state insurance guaranty funds is to make good on the outstanding insurance obligations of insolvent insurers. At the point where the assets of an insolvent insurer are insufficient to meet those claims obligations, the guaranty funds pay the balance up to the limits set by state statutes. The funding of those payments comes from the assessments of the remaining insurers, which range from one to two percent of premium volume, but are pro rata to state market share in the lines of business in which insolvent insurers had engaged.

Each state has its own guaranty fund laws for life and health insurance and for property and casualty insurance. Some states have additional guaranty funds set up for workers' compensation and surplus lines insurance.[1] These state laws conform substantially to model laws adopted by the National Association of Insurance Commissioners (NAIC).

All states post-assess insurers to cover insolvent insurer claims except New York, which pre-assesses its property and casualty guaranty fund up to $200 million.[2] The insurers licensed in

[1] Florida, New Jersey, New York, and Pennsylvania have separate guaranty funds for workers' compensation insurance. New Jersey has a separate guaranty fund for surplus lines insurance.

[2] New Jersey, New York, and Pennsylvania preassess their workers' compensation guaranty funds.

ultimately, the state's insurance commissioner.

The state guaranty funds coordinate their work, especially with regard to multi-state insolvencies, through two national organizations -- the National Organization of Life and Health Insurance Guaranty Association (NOLHGA) and the National Conference of Insurance Guaranty Funds (NCIGF).

Now for what the funds have done.

The guaranty funds serve as an effective and efficient backstop to safeguard consumer interests in cases of insolvency. The funds have:

-- paid more than $14 billion in the last 25 years to policyholders;

-- grown in financial capacity;

-- done so at no direct cost to state or federal taxpayers;

-- prioritized human needs;

-- assured continuance of coverage to policyholders of insolvent insurers;

-- worked in a comprehensive way to avoid duplication and coordinate activities on a multi-state basis;

-- continued to innovate, testing new ideas and searching for further efficiencies;

-- shown that a competing federal guaranty fund would harm rather than help protection now afforded policyholders; and

-- shown that guaranty funds work and do not need to be fixed in any significant way.

AN EFFECTIVE SAFETY NET

Both the life and health and property-casualty insurance guaranty systems have done what state legislators intended them to do. Life and health insurance guaranty funds report that they have paid more than $5.5 billion in payment of claims and premium refunds since 1988.[3] The property and casualty insurance guaranty funds report that they have paid more than $9.3 billion in claims, premium refunds, and defense costs to over two million insurance consumers over the past 25 years.[4]

The funds have been there when needed. The property-casualty funds system has stood the test of Hurricane Andrew, which felled several insurers, as well as many other insolvencies caused by increases in the costs and severity of medical malpractice claims and expansion of

[3] NOLHGA
[4] NCIGF

Insurance Group became insolvent in 1985, resulting in $700 million in state guaranty fund payments, the largest amount for a single insurer in history. The system worked during the next four years, when five more national insurers were placed in liquidation, resulting in state guaranty fund payments of an additional $1.9 billion in claims.[6]

GROWTH IN FINANCIAL STRENGTH

State guaranty fund capacity has grown steadily over the years. Over time premium volume has increased, thus increasing the potential revenue from assessments. The capacity of guaranty funds has almost doubled from $2 billion in 1985 to more than $4.8 billion today. According to the NCIGF, even with what could to be the largest multi-state insolvency in the nation's history, that of Reliance, the projected costs to the guaranty funds would be well within the nationwide assessment capacity of the state guaranty fund network. Combined state annual assessments have never exceeded 35 percent of actual capacity.[7]

NO DIRECT TAX IMPACT

State guaranty funds operate and pay claims at no direct cost to the state treasury or taxpayers. The policyholders of all insurers ultimately bear the costs as a part of their premium payments. Sixteen states offset property and casualty insurer assessments through a reduction in premium taxes, while 45 states offset life and health insurer assessments. California, Hawaii, and New Jersey allow insurers to add policy surcharges. The remaining 31 states allow insurers to increase premium rates to cover the assessments.

RESPONSIVENESS TO HARDSHIP CASES

Over the years, guaranty funds have developed ways to deal with hardship cases to protect insurance consumers who are not able to cope with an uninsured loss. Thirty-one states have adopted "net worth" provisions designed to concentrate resources on protecting claimants with the least personal financial resources.[8]

COORDINATION, EFFICIENCIES

The NCIGF and the NOLHGA have helped to coordinate and expedite state efforts in multi-state insolvencies. For example, when a multi-state insurer is declared insolvent, NOLHGA or the NCIGF usually form a task force of guaranty association members representing the impacted states. The task force then develops a coordinated plan for guaranty associations to provide coverage to policyholders on a fair and timely basis.

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[5] According to the NCIGF, in the past several years, insolvent insurer losses have been impacted by the expansion of toxic and environmental tort liabilities. In addition, the increase in the frequency and cost of medical malpractice claims has bankrupted some insurers, and the soft workers' compensation market has brought other insurers close to peril. The NCIGF says: "The State guaranty fund system has withstood all of these events and has continued to meet its obligations and pay claims without interruption."

[6] Between 1985 and 1989, Transit Casualty Company, Ideal Mutual Insurance Company, Midland Insurance Company, Integrity Insurance Company, Mission Insurance Group and American Mutual Insurance Company all became insolvent.

[7] NCIGF

[8] NCIGF

facilitated the negotiation of global settlements of environmental claims between groups of insurers and several state guaranty funds.

Property-casualty guaranty funds have overcome issues related to residency when corporate insureds operated in several states. Such situations have led, in the past, to disputes between the funds and among regulators and to uncertainties among claimants and other insureds. In such cases, the arguments really hinged upon which state guaranty funds should pay what claims. Guaranty funds now a have a system for resolving residency disputes between themselves, before the insured becomes involved.

IMPROVEMENT IN HANDLING INSOLVENCIES

NOLHGA has handled more than 40 insolvencies in recent years. But more importantly, there have been improvements in the speed of administering insolvencies. Ten years ago the handling of a life insurance insolvency took two and one half years. By the late 1990s, such processing sometimes took as little as three months, mainly as a result of reinsurance agreements.

There have also been improvements in the quality of that administration, for example, in the transfer of coverage applicable to a policyholder of an insolvent life insurer to a financially sound life insurer. Life guaranty associations have recognized that the sale of estate assets during a down period in the bond market could result in reduced benefits for policyholders and higher costs to the guaranty associations. In one insolvency, the funds worked with a receiver to organize a new company to assume the bonds of the insolvent insurers' non-insurance subsidiaries. As the value of those assets grows, more money can go to the guaranty association and policyholders, far more than if the receiver had sold them at a fire sale right after a finding of insolvency.

Life guaranty funds also now work with receivers to use so-called liquidating trusts to recover assets. The idea involves setting up a trust that assumes the insolvent insurer's non-liquid assets, maximizes them, and sells them. It has worked to increase funds available to policyholders in several insolvencies.

RESIDUAL MARKETS AND POOLS

States have also established many different residual market programs to make available insurance to individuals and businesses having difficulty obtaining coverage where the normal market has ceased to function effectively. Residual markets are important for high-risk applicants or individuals and businesses with a poor loss record. Businesses are considered high risk if they have inadequate safety measures in place, the nature of their work is hazardous, the threat of lawsuits is high, or if the location of the business is conducive to theft, vandalism, or severe natural catastrophes.

Residual market insurance premiums are set at a lower level than they would be if they were established on a strictly actuarial basis. Therefore, coverage is attainable for everyone who wants or needs insurance. Profits and losses of each residual market program are shared by all the insurers in a state selling a specific type of insurance. Residual market programs are rarely insurance consumers.

The state residual market and pooling mechanism is a proven success and its use continues to grow. For example, over the past several years, property insurers along the East Coast have been withdrawing from coastal states to reduce their exposure to hurricane losses. To compensate for the resulting lack of available coverage, states set up beach and windstorm plans to provide coverage to residents who live in shoreline communities. Between 1992 and 1999, the residual plans' exposure grew from $17 billion to $112 billion.

Another example is the automobile residual market. 41 states and the District of Columbia currently use automobile insurance assigned risk plans to guarantee that auto insurance is available to those who need it. Under the programs, when an applicant is unable to secure auto insurance, the state coordinating office randomly distributes applications to all insurance companies that offer auto liability coverage in the state, in proportion to the amount of their normal business. The insurers must provide coverage to these individuals and assume the losses. However, they are able to restrict the coverage limits and charge significantly higher premiums. Together, the nation's auto residual market programs insured about 3.4 million cars in 1998, or 2.1 percent of the total market.

Some other examples of residual market and pooling mechanisms within the states include: Joint Underwriting Associations (JUA's), Market Assistance Plans (MAP's), Fair Access to Insurance Requirements (FAIR), Rural Risk Plans, Workers' Compensation Assigned Risk Plans and Second Injury Funds, and Unsatisfied Judgement Funds.

THE HARMFULNESS OF A COMPETING FEDERAL SAFETY NET

Against this backdrop, the idea of a separate and competing federal guaranty system of insurers operating under a federal charter, such as those proposed in Congress by Sen. Schumer (NY) and Rep. La Falce (NY), could not help but weaken the state-based system. It would weaken the strong state consumer safety net, deplete its capacity from $4.8 billion to less than $3.0 billion[9], and reduce its overall risk pools. It would build another layer of overhead, create duplication in process and add unnecessary expense.

We believe the system has worked well. It is in no way broken. Congress, I respectfully submit, does not need to fix it, replace it, or establish anything parallel to it.

ISSUES BEFORE THE FUNDS

None of this is to say that the present guaranty fund system is perfect. Questions can still arise as to which guaranty law might apply to losses involving residents of different states. The NAIC has developed and recommended the establishment of priority rules based upon the respective residences of the insured, the claimant, and the property insured. NCIGF has implemented a mediation process for guaranty funds for use in cases where there is uncertainty of state responsibility among funds.

Assessments have, at times, presented problems. The up to one to two percent difference among states in assessment limitations has caused some problems. But, when faced with such

[9] ggggg

issues, individual state guaranty funds have been able to raise additional needed funds. In the aftermath of Hurricane Andrew, Florida's guaranty fund lacked sufficient assessment capacity in a single year. Florida overcame the deficit through a bond issue. It paid back the principal and interest in later years through assessments.

Another issue arises from the lack of uniformity of coverage limits and the types of coverage offered under different state guaranty fund laws. The range in maximum payment limits ranges from $50,000 per claim to as high as $1,000,000, though most states have limits ranging from $100,000 to $300,000 per claim. Most states, however, do not apply any cap to workers' compensation claims. In a 1992 report, the General Accounting Office (GAO) noted that persons residing in different states could receive less or more in payments for the same claim depending on the different state limits.

Such differences, I submit, exist for good reason. Property prices, state tort laws and property market values vary widely among states. Uniformity could lead to uneven treatment.

Since 1992, when NCOIL endorsed the NAIC models acts I have referenced above, NCOIL saw the need for an interstate compact which would govern, among other things, multi-state insolvencies. NCOIL's adoption followed public hearings in Indianapolis in 1991, San Antonio in 1992 and New York City in 1994. The proposed compact evolved into what is today the Interstate Receivership Compact (IRC). That compact was developed by Commissioners in the NAIC Midwest Zone and NCOIL legislators. That compact remains untested, due mainly to the fact there have been no receiverships for it to process and because of the low number of participating states. NCOIL is working with other states to increase the membership of the IRC.

While guaranty funds stand well today, we believe continued oversight is absolutely essential to the continuance of their effective function. We submit that an interstate compact idea is one that is available if needed. Simple expansion of the receivership compact would be one way to approach it.

But for now the guaranty fund system does not require the focus of Congress, although your constructive oversight is welcomed and appreciated.

FINANCIAL MODERNIZATION

Worthy of all our attention is regulatory modernization. It is proceeding. I will focus the balance of my testimony on that subject. To a great extent what follows will update the testimony before this subcommittee of former NCOIL President, State Representative Terry Parke of Illinois, on June 21, 2001.

Technological changes and globalization of insurance markets have challenged the states to modernize the regulation of the business of insurance. Essential states need to do three things. States need to establish (1) a one-stop, reciprocal and uniform system of licensing; (2) a fast, centralized system for policy form and rate approvals; and (3) a fundamentally reformed system of market conduct regulation.

States are well on their way to achieving each of these goals.

States are enacting laws that provide for reciprocity in agent and broker licensing. The states beat the NARAB deadline established by GLBA by more than 18 months.

States are beginning to consider proposals for the national chartering of insurance companies within a state based regulatory system. NCOIL will consider such a proposal for one-stop shopping for insurance company licenses at its upcoming meeting in Boston in July.

NCOIL continues to believe that company licensing is an area that lends itself to the use of an interstate compact. New York State Senator Neil Breslin made that point in testimony before the House Commerce Committee at a hearing chaired by Representative Oxley on July 20, 2000.

The NAIC has developed a draft of an interstate compact that would allow for a single point of filing for life insurance and annuity contracts. NCOIL is presently reviewing that draft in the expectation of giving its input and support to the NAIC in this important enterprise. NCOIL has a long established record of support for interstate compacts in insurance regulation. The present NAIC draft borrows on the procedures provisions of the NAIC Midwest Zone - NCOIL Interstate Receivership Compact referenced earlier in this testimony.

More than 20 states have achieved speed in rate and form approval with the adoption of the NCOIL Commercial Lines Deregulation Model Act. Since the June 2001 hearing, NCOIL has adopted a model Property/Casualty Insurance Modernization Act. It would remove premium rate approval requirements in both commercial and personal lines.

States, through a comprehensive market conduct study in 1999, identified areas where there is need of market conduct regulation reform. That study found duplication of effort and lack of coordination and training in market conduct regulation. It also discovered widespread disagreement with respect to the purpose of market conduct regulation.

NCOIL has decided to conduct a second and final study of market conduct regulation. That study will make findings relative to the goals of market conduct examination and the specific means for achieving those goals. It is our goal to bring market conduct examination of insurers to the same level of efficiency, coordination and effect now associated with examinations of insurer financial strength.

I thank you again for the opportunity to provide this testimony and I would be happy to answer your questions.

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A P P E N D I X

June 11, 2002

Opening Statement

Chairman Michael G. Oxley

Committee on Financial Services

Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises
"Insurance Regulation and Competition for the 21st Century"

June 11, 2002

Today, insurance represents one of the critical foundations for our nation's infrastructure. In fact, insurance now represents about 6 ½ percent of consumer household spending, exceeding entertainment, clothing, and health care. Insurance has become an integral part of consumers' lives, and without it, few people would be able to own homes, drive cars, obtain medical care, or provide retirement security for their families. And yet, our American insurance marketplace is entering into a time of crisis.

States collect enormous revenues from insurers, spending only a fraction on insurance regulation and consumer protection. Some States fix prices below the levels necessary to attract adequate capital, even where extensive competition does or could exist. And each State imposes its own regulatory regime for formal approval, creating long delays for consumers and making it impossible for insurers to provide products uniformly nationwide. Consumers ultimately bear the costs of this reduced competition and innovation.

The current patchwork system of insurance regulation also has far reaching international consequences. The financial services marketplace is rapidly becoming more global, with our trade negotiators prying open foreign markets to American products. But we cannot be strong overseas if we are not strong at home. And we cannot argue that foreign markets need to be more open and transparent, when our domestic market is still Byzantine and impenetrable.

To remain competitive, we need to speak with one voice from our country, to harmonize international regulations and ensure adequate consumer protections and solvency oversight. Consumers can not be adequately protected if insurers are subjected to conflicting requirements at the international, Federal, and State levels.

It is my primary hope that our State legislators and insurance commissioners can enact meaningful reform. The States have had some success: significant progress in agent licensing reform, solvency oversight and accreditation. I would note however that this success is far from complete and has only occurred in the face of Congressional legislative pressure, pressure that will continue to grow if the pace of reform does not improve.

Numerous groups have now come forward to our Committee desperate for reform. In fact, some people have tried to take advantage of this by "jumping the gun" and coming forward with proposals before the Committee has had a chance to fully review the great number of issues that Congress needs to analyze in considering any proposals. But we cannot and will not risk such an important foundation of America's infrastructure without understanding all the risks involved and developing a public record with all industry and consumer groups participating.

We are just beginning to search out a consensus on what reforms might be achievable. Our goal is an industry that is competitive and profitable and brings consumers the efficiency and effectiveness they deserve.

I appreciate our witnesses making the time today to help us grapple with these very difficult issues, and look forward to their testimony. I would like to offer a special welcome to Joe Gasper, the President and Chief Operating Officer of Nationwide, a great company headquartered in my home state of Ohio.

June 11, 2002

Opening Statement for Congressman Paul E. Gillmor
House Financial Services Committee Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises Hearing
"Insurance Regulation and Competition for the 21st Century" Day 2

I would like to thank Chairman Baker for holding this important hearing this afternoon, the first in a series of discussions on how best to reform and modernize our current insurance regulatory system.

I enjoyed hearing the opinions of our distinguished witnesses on our first day of hearings and look forward to hearing from our witnesses on several reform proposals that have already come to the committee's attention. I would like to extend an especially warm welcome to Mr. Joseph J. Gasper, President and Chief Operating Officer of Nationwide Financial Services in Columbus, Ohio and Chairman of the Board of Directors of the American Council of Life Insurers (ACLI). Mr. Gasper, thank you for traveling from the great State of Ohio to be with us today and I look forward to your comments.

I continue to believe that before this committee considers any substantive legislation in this area, lengthy discussions must take place considering all the ramifications of changes such as optional federal chartering, interstate compacts, and federally targeted uniformity proposals. The series of hearing continuing today, provide the perfect opportunity for such exchanges and debate.

As a member of the House Energy and Commerce Committee during the consideration of the Gramm-Leach-Bliley Act (GLBA), I remember the intense debate surrounding federal regulation of the insurance industry. As in other areas addressed in the GLBA, it is important that we review the implementation of the agent licensing standards, and assess the changes in the industry as a result, before considering additional new regulations.

It is widely agreed that the time for modernization of insurance regulations has come and I commend our subcommittee chairman for realizing the importance of this issue. I hope today's discussion and those to come will lead us toward a reform proposal that addresses the concerns of those most supportive of optional federal chartering while continuing to improve state regulations.

Again, I would like to thank the chairman for holding today's hearing and our witnesses for joining us. I look forward to a continued healthy exchange of ideas.

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Steve Israel

Opening Statement
Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises
Committee on Financial Services
Hearing (Day 2) on Insurance Regulation and Competition for the 21st Century
June 11, 2002

Mister Chairman, in Day 2 of this important set of hearings, we will hear from six very important elements of our insurance industry. I thank all of the witnesses for coming today and look forward to hearing your statements.

As I said last week, I am still developing my views on the issue of an optional federal insurance charter. Many people from different parts of the industry have discussed the merits and drawbacks of an optional charter with me since I came to Washington last year. The issues involved, while complex, are at the very heart of our financial system, and affect people dramatically.

We do know many things for certain: the interests of consumers must be protected. Our regulatory regime must continue to work in a way that encourages innovation and allows companies to respond to market forces quickly. Our insurance system should reflect the realities of today's world, not the world as it was decades ago. A balanced playing field for all participants in the financial services sector, from banks to brokerages to insurance companies, should be our ideal. This Committee and this Congress should not be in the business of picking winners and losers.

Once again Mister Chairman, I commend you on beginning this conversation formally. I appreciate the fact that our witnesses are participating in this discussion. I know that I will learn a lot from this and next week's hearing. I believe that these are the kinds of oversight hearings that our Committees should do on a more regular basis, giving Members the opportunity to look in depth at important issues. Once again, thank you.

OPENING STATEMENT OF
RANKING DEMOCRATIC MEMBER PAUL E. KANJORSKI

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES

SECOND HEARING ON INSURANCE REGULATION AND COMPETITION FOR THE TWENTY-FIRST CENTURY

TUESDAY, JUNE 11, 2002

Mr. Chairman, today we meet for a second time to analyze various proposals to increase the efficiency and uniformity of insurance regulation. I again commend you for your diligence in convening this series of hearings. Today's witnesses should help us to better understand the procedures for introducing new insurance products and the process of solvency examinations.

At our last hearing, we heard from both sides of the ongoing policy debate about reforming insurance industry regulation and creating an optional federal insurance charter. Some of our witnesses argued that the needed reforms are most appropriately pursued at the state level. Others suggested that a dual-regulatory structure at the state and federal level would most adequately address the problems plaguing the industry. We will hear similar arguments today.

No matter what side one takes in this long-standing debate, it has become clear to me that this is no longer a question of whether we should reform insurance regulation in the United States. Instead, it has become a question of how we should reform insurance regulation.

This reform effort will likely prove difficult. After all, the American insurance industry, as I noted at our last hearing, is broad and diverse. According to one estimate, we have nearly 5,800 insurance companies operating in the United States. These companies vary greatly in size, structure, and product offerings. As a result, I suspect that it will take us at least several years to forge a consensus on this complicated set of issues.

Later today, I plan to continue to explore whether we should create a tiered regulatory structure for insurance, similar to the oversight system we devised for investment advisors. Under this system, the federal government would regulate insurers above a certain size or in certain business lines, while states would retain the responsibilities for regulating the rest.

During today's hearings, we should also continue to carefully examine consumer issues. We should, for example, determine the costs and benefits of a streamlined regulatory system. We should additionally determine what safeguards are needed to protect consumers' interests. In the end, consumers should be the ultimate beneficiaries of our actions.

Moreover, as we proceed today, we should explore how international forces continue to change in the insurance marketplace. From these discussions, I expect to learn that the American system of insurance regulation must evolve into a more streamlined model in order to remain globally competitive in the long term.

In closing, Mr. Chairman, I look forward to hearing from our distinguished witnesses and to learning more about their views for improving insurance industry regulation. As we continue to examine these issues, I am confident that our careful analysis will allow us to eventually identify a bipartisan consensus on the most effective and appropriate way to proceed.

Opening Statement
Congressman Ed Royce (CA-39)
11 June 2002
Insurance Regulation and Competition for the 21st Century

Thank you, Mr. Chairman, for the opportunity to address the issues pertaining to insurance regulation and competition raised by these two panels of witnesses here today. Specifically, the two issues that I would like to address, and that I think are particularly worthy of this committee's attention, are related to the general competitiveness of the American insurance industry -- specifically, the speed-to-market for domestic insurance products and the fairness of international competition for American insurance and reinsurance providers.

The first issue -- speed-to-market for domestic insurance products -- is of great concern because of its great financial implications for the consumers of insurance products as well as for those companies which supply these products and services. As the diffuse system for insurance regulation stands right now, an insurance company wanting to release an innovative new product to meet consumer demands in multiple states faces a waiting period of between 18-36 months for regulatory approval in each of its target states. Because of this bureaucratic inefficiency, insurance companies incur a great deal of costs in paperwork and lost revenue which must ultimately be passed on to consumers in the form of higher prices. Additionally, because the cost of dealing with regulatory hurdles and bureaucratic red-tape is prohibitively high in some particularly onerous states, many companies choose not to develop or to market innovative products at all in states where there is a significant consumer demand.

In short, it seems that we are finding in the insurance industry some examples of how the piecemeal and *ad hoc* regulation of insurance products by the many states has stymied product innovation while limiting consumer choice and raising costs. This is a situation that I believe needs to be studied by this committee, and I look forward to hearing from our witnesses what steps the federal government can take to fix this serious and costly problem.

The second issue -- the fairness of international competition for American insurance and reinsurance providers -- is of great concern because of its implications for the rigor of American regulation as well as for the overall competitiveness of these American companies. The issue of granting mutual recognition of reinsurers between the United States and other countries is troublesome to me because of the possibility that some foreign-based reinsurers may use it as way to gain access to the lucrative American market without having to comply with the same level of supervision and soundness safeguards as American-based firms, or to weaken the overall regulation of the American reinsurance market. Another international issue at hand is the barrier-to entry issues raised by some of our trade partners in regard to the American insurance regulatory system, which I think must be dealt with to ensure that American consumers are given the safest, widest and most competitive variety of insurance products possible.

I commend the chairman on his leadership on these issues, and I look forward to gleaning further information from our witnesses today to see what Congress can do to address these and other issues associated with insurance regulation and competition in the 21st Century. I yield back the balance of my time.

STATEMENT OF

THE AMERICAN COUNCIL OF LIFE INSURERS

BEFORE THE

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND GOVERNMENT SPONSORED ENTERPRISES OF THE COMMITTEE ON FINANCIAL SERVICES OF THE UNITED STATES HOUSE OF REPRESENTATIVES

ON

INSURANCE REGULATION AND COMPETITION OF THE 21ST CENTURY: PRODUCT AND FINANCIAL REGULATION

June 11, 2002

Statement Made by

Joseph J. Gasper
Chairman, ACLI
President & Chief Operating Officer
Nationwide Financial Services, Inc.

Mr. Chairman and members of the Subcommittee, my name is Joe Gasper, and I am President and Chief Operating Officer of Nationwide Financial Services in Columbus, Ohio. I am appearing today on behalf of the American Council of Life Insurers, the national trade association representing legal reserve life insurance companies. I am also Chairman of the Board of Directors of the ACLI and chair of the ACLI's CEO task force overseeing the development of an optional federal charter for life insurers.

I appreciate the opportunity to appear before you today to discuss the pressing need to modernize the life insurance regulatory framework in order for it to accommodate the life insurance business of the 21^{st} century. Let me state clearly that the adoption of an optional federal charter now stands as the top priority issue for our business, and for this reason we are pleased that you are holding this timely series of hearings.

We believe the establishment of an optional federal charter is critical to consumers and to the economic stability of the United States as it relates to providing for an aging population who will depend upon the services only life insurance products provide; guaranteed income, long term care, and financial protection. As the Congress faces the Social Security and Medicare challenges in the next fifty years, it will need a high performing life insurance industry to partner with and help shoulder the burden.

As the needs and circumstances of both life insurance companies and their customers have evolved, our system of regulation has failed to keep pace. Life insurance used to be a relatively local business, with the activities of many companies conducted within the boarders of a single state. Indeed, when our state-based regulatory system was established, insurance was not even deemed to be "interstate commerce." Yet today, life insurers are typically national if not global enterprises.

I would like to spend just a few minutes highlighting some of the changes our business has undergone, which will help explain why regulatory modernization, ***in the form of an optional federal charter,*** is nothing short of a survival issue for us.

A generation ago, the average life insurer took in almost 90% of its premiums from the sale of life insurance, compared to only 13% from annuities. Today, those numbers are almost completely reversed, with 70% of premium receipts coming from annuities compared to only 30% from life insurance products. The business mix of my company, Nationwide Life, reflects that trend: last year, 10% of my business come from individual and group life proceeds, 30% from individual annuities and 60% from group annuities.

Today, life insurers administer over $1.8 trillion in retirement plan assets, amounting to over 25% of the private retirement plan assets under management in the U.S.

These fundamental changes in the life insurance industry make several things clear to me:

- The market my company serves is no longer predominantly the life insurance market – it is the retirement security market;
- For that reason, my company is competing head-to-head with non-traditional competitors in that market as we offer products designed to accumulate and protect customers' assets;
- Regulatory fragmentation and inconsistency creates administrative complexity and increases administrative costs, which makes it very difficult for my company to compete effectively with those who benefit from a more consolidated, streamlined, and efficient federal regulatory system; and finally,
- To survive and prosper in this environment, companies must be nimble, and rapid adjustment to changing market and competitive circumstances is a must.

In this intensely competitive market, life insurance company executives like me are doing everything we can within our companies to become more efficient and to more effectively serve our customers. Toward this end, we must offer valuable, cost-efficient products and services. However, there is only so far I can take my company absent a uniform, coordinated, efficient national insurance regulatory system.

I hope to impress upon you how tremendously important regulatory modernization efforts are to the life insurance industry, and what steps we feel are essential to ensure that this modernization takes place in an appropriate and timely manner.

The Current Regulatory Environment: Lack of Uniformity Hampers Multi-State Insurers

A significant impediment for multi-state insurers is the current state-based system's inability to produce, in crucial areas, both uniform standards and consistent application of those standards by the states. I'd like to give you a brief outline of the business and regulatory complexities commonly faced by life insurers under the current system.

Before a company can conduct any activities, it must apply for a license from its "home" or "domestic" state insurance department. A license will be granted if the company meets the domestic state's legal requirements, including capitalization, investment and other financial requirements, for acting as a life insurer. If the company wishes to do business only in its home state, this one license will be sufficient. However, in order to sell products on a multistate basis, a company must apply for licenses in all the other states in which it seeks to do business. Each additional state may have licensing requirements that deviate from those of the company's home state, and the company will have to comply with all those different requirements notwithstanding the fact that the home state regulator will remain primarily responsible for the insurer's financial oversight.

Once a company has all its state licenses, it can turn its attention to selling policies. To do that, a company must first file each product it wishes to market in a particular state with that state's insurance department for prior approval. A company doing business in all states and the District of Columbia must, for example, file the same policy form 51 different times and wait for 51 different approvals before selling that product in each jurisdiction. And this process must be repeated for each product the insurer wishes to offer. Since these 51 different insurance departments have no uniform standards for the products themselves or for the timeliness of response for filings, a company may receive approval from one or two jurisdictions in 3 months, from another ten jurisdictions in 6 months, and may have to wait 18 months or longer to receive approval from all jurisdictions.

This process is further complicated by the fact that each insurance department may have its own unique "interpretation" of state statutes, even those that are identical to the statues in other jurisdictions. As a result, a company will be required to "tweak" its products in order to comply with each individual department's "interpretation" of what otherwise appeared to be identical law. Since a company has to refile each product after it has been "tweaked," the time lapse from original filing to final approval can very well be double that which was originally expected. And, as a result of the various "tweaks," what started out as a single product may wind up as thirty or more different products.

After a company has received approval to sell its products in a state, it needs a sales force to market those products. Here again we encounter the inefficiencies of the current state system. Each state requires that anyone wishing to act as an insurance agent first be licensed as such under the laws of that state. Each state has its own criteria for granting an agent's license, and this criteria includes differing continuing education requirements once the license is issued. Like companies, insurance agents wishing to work with clients in more than one state must be separately licensed by the insurance departments in each of those states. And, because of the differing state form filing requirements for companies noted above which results in products being "tweaked" for approval in each of the various jurisdictions, persons granted agent licenses by more than one state will not always have the ability to offer all clients the same products.

After this multitude of licenses and approvals has been secured, a company can begin to sell products nationwide. However, the lack of uniformity in standards and application of laws will continue to be a complicated and costly regulatory burden that the company must constantly manage. The very basic things that any business must do to be successful--such as employing an advertising campaign, providing systems support, maintaining existing products, introducing new products and keeping our sales force educated and updated--are all affected 51 different sets of laws, rules and procedures under the current regulatory structure.

Add to this the fact that states also police actual marketplace activity by subjecting a company to market conduct examinations by the insurance departments of every state in which it is licensed. Even though state market conduct laws nationwide are based on the same NAIC model laws, there is minimal coordination on these exams among the various states. As a result, a company licensed to do business in all 51 jurisdictions is perpetually having states initiate market conduct examinations just as one or more other states are completing theirs, with the cost of each exam being borne by the company. And, because these examinations are largely redundant, the benefits derived relative to the costs incurred are marginal at best.

In sum, these issues result in very real costs in terms of money, time, labor and lost business opportunities attributable to this cumbersome state regulatory system, which places a great competitive burden on individual companies, and on the industry as a whole.

Examples of Regulatory Inefficiency

Let me give you a few real-world examples of how a company like mine that does business nationally is affected by regulatory inefficiency.

Last year, Nationwide developed and filed in throughout the country a very important annuity product for contract owners interested in market timing. Seven months later, approval was still pending in five jurisdictions, four of which were major market states.

You may be saying to yourself, approval in over 40 states in seven months is not that bad. The truth is, to sell this product on a national basis and still comply with individual state requirements, Nationwide had to create **35 separate, state-specific contracts!**

The time and cost associated with complying with these state variations can be enormous. For example, one large state in which we do business adopted standards in a key regulatory area that are entirely different from those of other states. The result: an additional $500,000 in annual, ongoing expenses associated with hiring the staff and developing a compliance system needed to administer this single state variation alone.

Another concern is the impact of the state approval process on product innovation and consumer choice. Over the last few years, we attempted to bring to market an annuity with a long-term care conversion feature. We think this would help address two important retirement savings needs for consumers. We ended up shelving the product for the time being, however, after having it approved in nine (9) states and disapproved in (9) states. Now, you can look at this several ways, but ultimately you have to say nine states were right or nine were wrong. We believe that the nine who disapproved the product were wrong and that ultimately the consumer lost an important innovative financial tool for managing their assets in retirement.

A related example of a product we are currently marketing involves a modified guaranteed annuity. It is a variable annuity product that it is registered with the SEC. It was designed to compete with bond funds offered by mutual fund companies. While this product has been approved in 45 states, it cannot be sold nationally because some individual state requirements – both written and unpublished – either prohibit the contract design or require costly system changes that cannot be justified for a single state.

All this means that it remains extremely difficult and expensive, if not impossible, to develop a product today that can be marketed and advertised nationally. There are simply no compelling reasons why the majority of products and services offered by life insurers should be subjected to standards that vary so considerably from state to state.

ACLI Policy on Improving Regulatory Efficiency and Modernization

The ACLI Board of Directors, after careful consideration and extensive discussion with member life insurance companies, insurance regulators and others, determined to approach improving regulatory efficiency and modernization on two tracks. One is to work with the states and the NAIC to improve a state-based system of regulation. The other is to work with Congress to put in place a federal charter option for life insurers. My remarks today will be confined to the latter, although I would note that the ACLI is, and will remain, fully committed improving our state-based insurance regulatory framework.

A Federal Charter Option: Key Considerations

The ACLI spent approximately a year and a half developing draft legislation providing an optional federal charter for life insurers. This effort involved over 300 ACLI member company representatives and brought to bear their considerable expertise on literally every aspect of life insurance regulation. This draft was widely circulated on Capitol Hill and within the insurance industry and elsewhere for reaction and comment.

The American Insurance Association and the American Bankers Insurance Association also developed draft optional federal charter legislation. The ACLI is working closely with these groups to arrive at a consensus draft, and we are well along in that effort. Under the auspices of the Financial Services Coordinating Council, a broad cross-section of the financial services industry has already agreed on a common set of principles relative to an optional federal charter. A copy of these principles is attached to my statement.

The ACLI staff can respond to questions you may have on the technical underpinnings of our draft legislation or the consensus draft legislation that is nearing completion. I would like to use my time this afternoon to discuss several points regarding the general concept of an optional federal charter.

Congress Should Avoid Incremental Federal Legislation

There have been suggestions that Congress should defer action on optional federal insurance charter legislation and instead see whether an incremental approach to regulatory efficiency might suffice. For example, discrete issues such as product approvals or coordination of market conduct examinations might be addressed along the lines of the NARAB provisions included as part of the Gramm-Leach-Bliley Act.

Quite candidly, Mr. Chairman, I would argue strongly against this approach for a number of reasons. First, the effort of the states and the NAIC to enhance regulatory efficiency is, by its very nature, incremental. The states have identified several priority issues to tackle, and they are developing concepts to deal with them. Achieving some form of overall "national treatment" under a state regulatory regime should be an ultimate goal, but even the states have recognized that it is impractical to seek to achieve that goal in the near term. We simply do not need the states **and** the Congress employing incremental approaches to regulatory modernization.

As noted above, the ACLI Policy on Improving Regulatory Efficiency and Modernization includes working with the states and the NAIC to improve state-based regulation. While we salute the NAIC and others for their efforts toward this end—and in fact we and our member companies are working with them at the state level—the ACLI believes that this effort should not be exclusive of but rather complementary to the pursuit of an optional federal charter for insurers. Here's why.

One of the fundamental values of a federal charter option is that it can achieve uniformity of insurance laws, regulations and interpretations the moment it is put in place. And only Congress can enact legislation that has this broad-based, immediate effect. As I noted at the outset, many life insurers believe regulatory modernization is a survival issue, and in that context the speed with which progressive change takes place is critical. Today's marketplace is intolerant of inefficient competition. And the prospect of having to wait a number of years to see whether incremental federal legislation will even be enacted, and then, if it is, having to wait for some additional period of time to see whether it works is not even remotely appealing to me. Because if the answer turns out to be "no," my business will likely have become irrelevant long before any meaningful steps have been taken. I, for one, am not willing to take that risk.

In my judgment, Congress should not "finesse" this issue by putting a clock on the states either to force them to perform better or to see how much they can accomplish over some set period of time. This approach ultimately sidesteps the responsibility to protect a vital industry and the consumers it serves.

I believe Congress should focus its attention on a global, comprehensive alternative to state insurance regulation expressly crafted to meet the needs of today's national and multinational insurers. I believe an immediate and concerted effort to put in place an optional federal charter is the best course of action for providing needed regulatory solutions for our industry and for providing the states with strong incentive for improving their regulatory structure.

In sum, the ACLI will work with the states to pursue important but incremental improvements to state insurance regulation. But we will look to Congress for the improvements that only Congress can provide in the form of an optional federal insurance charter.

An Optional Federal Charter Is Not an Attack on States' Rights

Insurance is the only segment of the U.S. financial services industry that does not have a significant federal regulatory component. Under the optional federal charter concept being advanced by the ACLI and others, the states would retain a greater, or at least as significant, a role in insurance regulation as their state regulatory counterparts now have in the banking and securities industries.

The federal charter proposal does not mandate federal insurance regulation of all insurers. Rather, it allows an insurance company the option of seeking a federal charter if company leadership believes that to be more complementary to the company's structure, operations or strategic plan.

It is not an affront to states' rights to seek the elimination of conflicting or inconsistent laws. A principal objective of the ACLI proposal is to reduce the regulatory burden caused by such conflicts and redundancies and to do so by adopting the best state laws and regulations as the applicable federal standards.

A further objective of the federal charter option is to modernize the insurance regulatory framework and, in so doing, make insurers significantly more competitive in the national and global marketplace. Enhancing competition is a sound and legitimate role for Congress and substantially outweighs concerns over any diminution of the regulatory role of the states.

The importance of insurance protection was underscored by the events of September 11, as was the fact that it is in the national interest to have a federal authority with expertise and involvement in the U.S. insurance industry given the industry's significant and substantial importance to the overall financial health of the nation. Establishing an agency to fill this void is not, and should not be characterized as, a diminution of states' rights.

Finally, the concept of an optional federal charter is far less an infringement on states' rights and prerogatives than preemptive federal standards, minimum or otherwise. The latter apply to all insurers and suggest that the states are incapable of dealing with important regulatory matters even as they pertain to state chartered carriers.

An Optional Federal Charter Will Not Foster Regulatory Arbitrage

Some have suggested that the implementation of a federal charter option will lead to regulatory arbitrage and a regulatory "race to the bottom" as companies seek increasingly lax regulation and regulators rush to accommodate. Nothing could be further from the truth.

First and foremost, the ACLI and its member companies are not seeking to migrate to a federal system of insurance regulation that is lax. To the contrary, we are seeking an strong regulator located in the Treasury Department that will administer a comprehensive system of regulation predicated on the "best-of-the-best" drawn wherever possible from existing state statutes or NAIC model laws. Only where the state system is irreparably broken (e.g., the product approval process) have we sought to create new regulatory concepts.

Second, the notion that adding one more system of regulation on top of the 51 that already exist will somehow give rise to regulatory arbitrage is groundless. Today, companies have the right in virtually all jurisdictions to change their state of domicile – that is, to move to a different state that would have primary responsibility for the company's financial oversight. Consequently, there are 51 opportunities for regulatory arbitrage today.

It is inconceivable that Congress would put in place a federal regulatory option that was not at least as strong as the better - if not the best - state system. How, then, would we be creating some new opportunity for this dreaded "race-to-the-bottom?" What possible harm would come from companies moving to a federal system of regulation that is as strong as, if not stronger than, the one they are leaving?

Inherent in this assertion of possible regulatory arbitrage is the notion that a company executive could wake up one morning and simply decide to flip a company's charter. Quite simply, business does not work that way. Such a change carries with it countless significant consequences and considerations and is not entered into lightly. It is costly, time consuming and initially highly disruptive. The notion of regulatory arbitrage implies that companies would be inclined to move into and out of regulatory systems on a whim or whenever decisions were made or likely to me made that would be adverse to their interests. In the real world, this does not and would not occur.

Insurance Will Not Be Regulated Like Commercial Banking

All the versions of optional federal charter legislation draw at least in part on the dual banking system. Critics have responded by suggesting that it would be inappropriate to regulate insurance companies like commercial banks. This criticism fails to distinguish between the administrative aspects of a federal charter (e.g., the form and location of the regulator, administrative due process, judicial review) and those aspects that involve the actual regulation of companies (e.g., solvency, investments, accounting, market conduct, and so on). It is only with respect to the former that we look to the bank model. The actual regulation of companies, looks almost exclusively to tried and proven concepts of insurance regulation mirroring or predicated on existing state insurance statutes or model laws.

The Federal Charter is <u>Optional</u>

We urge you to keep in mind that all proposals for a federal insurance charter call for that charter to be optional. Companies that do a local business or that for other reasons would prefer to remain exclusively regulated by the states are perfectly free to do so. Relatedly, the ACLI has worked hard to draft a federal charter option that, to the extent reasonably possible, remains "charter neutral." For example, we have avoided building into the federal option advantages (e.g., tax advantages) that companies would be hard pressed to turn their backs on even if they wished to remain state regulated.

While individual motives may vary, our member life insurance companies are strongly united in our desire to modernize our regulatory system so we can regain our competitive footing and effectively serve our customers. Some feel that a federal charter is in the long-term best interest of their company and customers. Others have indicated they would prefer to remain state chartered even if a federal charter were available to them. Like other financial service firms, we believe insurers must have the ability to select the charter that best suits our operations, products, markets and long-term strategies.

An Optional Federal Charter Will Not Disrupt State Premium Tax Revenues

Opponents of an optional federal charter have suggested that if such an option were to become a reality, national insurers would, over time, somehow escape state premium taxes, which constitute a significant source of revenue for all states. This concern is totally unfounded.

As this Subcommittee knows better than most, with the exception of Government Sponsored Enterprises, all for-profit federally chartered financial institutions such as commercial banks, savings banks and thrifts pay state income taxes. For insurers, this state tax obligation takes the form of a state premium tax. There is no precedent for, nor is there any expectation of, exclusion from this state tax obligation. Indeed, all versions of the optional federal charter legislation expressly provide for the continuation of the states' authority to tax national insurers.

There is presently debate in some jurisdictions over whether insurers should pay a state net income tax in lieu of a state premium tax. This debate will continue irrespective of whether there is an optional federal insurance charter. Simply put, state tax revenue is not a material factor in the debate over an optional federal charter.

Consumer Protections Will Not Diminish Under an Optional Federal Charter

We believe insurance consumers will also benefit if an optional federal charter becomes a reality. Strong solvency oversight and strong consumer protections are the cornerstones of any effective insurance regulatory system. The ACLI draft optional federal charter legislation and the consensus version being finalized by the ACLI and other interested groups is built on these cornerstones. In this regard, the draft legislation duplicates the following important aspects of state insurance laws:

- It guarantees that consumers are protected against company insolvencies by extending the current successful state-based guaranty mechanism to national insurers and their policyholders.
- It ensures the financial stability of national insurers by requiring adherence to statutory accounting principles that are more stringent (conservative) than GAAP.
- It duplicates the stringent investment standards currently required under state law.
- It mirrors the strong risk-based capital requirements of state law to ensure companies have adequate liquid assets.
- It duplicates state valuation standards that ensure companies have adequate reserves to pay consumers' claims when they come due.
- It reproduces the requirement that companies submit quarterly financial statements and annual audited financial reports.
- It mirrors the existing nonforfeiture requirements under state law that guarantee all insureds receive minimum benefits under their policies.

In addition, consumers who deal with national insurers may very well enjoy significant added protections and benefits over those afforded by the states. For example, consumers will experience uniform and consistent protections nationwide and will enjoy the same availability of products and services in all 50 states. Consumers will also benefit from uniform rules regarding sales and marketing practices of companies and agents, and for the first time consumer issues of national importance will receive direct attention from a federal regulator.

The Need for an Insurance Regulatory Presence in Washington

While Gramm-Leach-Bliley permits the integration of financial services companies (banks, securities firms and insurance companies), the last time there was major federal legislation affecting the *regulation* of life insurance companies was in 1944 when the McCarran-Ferguson Act was signed into law. Clearly, there has been a great deal of evolution in the structure, function, products and competitive landscape of the industry since then.

- A limited product line consisting mainly of whole life and term insurance products then has given rise to a wide array of sophisticated financial instruments---universal life, fixed and variable annuities, guaranteed investment contracts and other pension products, and long-term care insurance---many of which compete directly with similar financial products offered by banks and securities firms.

- While there were only a handful of companies doing business on more than just a regional basis then, many life insurers now have national operations, and an increasing number are multi-national financial service providers with facilities all over the globe.

- Life insurance companies have become the major source of long-term capital for our economy. Insurers are not only the principal sources of financing for apartment and office buildings, hotels and shopping centers, but are the largest investor in corporate bonds as well holding over $1.2 trillion in corporate debt. In addition, insurers are major purchasers of local, state and federal bonds used to finance the entire array of government-funded programs and projects, especially roads, schools and other infrastructure needs.

- Life insurers are one of the largest financial intermediaries with assets of over $3.1 trillion.

- As an industry, life insurance companies provide income security for most Americans, with some 163 million individual policies outstanding with a face amount of $ 9.4 trillion, and approximately 369 million group insurance certificates outstanding with a face amount of over $ 6.4 trillion.

- Nearly 73 million Americans own annuities backed by over $1.2 trillion in reserves.

The essential point here is that the life insurance industry is an increasingly significant part of the nation's economy. Insurers, along with the banking and securities industries, are the triumvirate of essential financial services providers. And yet, despite the striking parallels between the three in terms of their products and their importance to the financial health of the nation, there is no federal mechanism to address arising insurance issues on a broad scale. There is no federal repository of insurance expertise, no agency at the federal level to deal with, or even testify authoritatively about, critical issues affecting the industry. The recent debate over terrorism insurance coverage served only to underscore the existence of limited insurance expertise and the lack of authority at the federal level.

Over the past few years, it has become more apparent that a critical role of the banking and securities regulators is not just to protect consumers of those industries' financial products, but to ensure that the industries themselves remain healthy and competitive. When the Comptroller of the Currency or the Chairman of the Securities and Exchange Commission appear before Congress to describe issues affecting their respective industries, Members give substantial weight to their views. The simple fact is that insurance is too important an industry to be unrepresented by any federal agency.

To look at it another way, consider what would happen if there was an explosive decline in the stock market, but no SEC, no federal agency with a core of equity market expertise for Congress to turn to for guidance, no federal agency to reassure foreign markets and investors that there was a light at the end of the tunnel. Instead, Congress would be forced to query a succession of state securities regulators to try to piece together information on what went wrong and then try to come up with its own plan to address the problems, all within a very short time frame and under intense pressure. Can we afford to leave the insurance industry and its customers in a similar position?

Conclusion

Life insurers today operate under a patchwork system of state laws and regulations that is not uniform and that is applied and interpreted differently from state to state. The result is a system characterized by delays and unnecessary expenses that harm companies and disadvantage their customers. Failure to reform insurance regulation will pose a severe and ever larger competitive burden that could threaten the viability of the life insurance industry and those it serves in an increasingly competitive global economy.

Mr. Chairman, we encourage you in the strongest terms to work with us to put in place an appropriate federal regulatory option available to insurance companies, insurance agencies, and insurance producers. It is in the best interests of our industry, its customers and our overall economy to do so as expeditiously as possible.

On behalf of the member companies of the American Council of Life Insurers, I would like to conclude by saying "thank you" to you and to the members of your Subcommittee for the opportunity to express our views on this most important subject.

Financial Services Coordinating Council

Representing America's Diversified Financial Services Community

Principles for Federal Insurance Regulation

The Financial Services Coordinating Council was formed by the four principal trade associations representing the major financial sectors of the U.S. economy to address issues of common concern at both the federal and state levels.

Its members are the American Bankers Insurance Association/American Bankers Association, American Council of Life Insurers, American Insurance Association, and Securities Industry Association. These organizations represent thousands of large and small banks, insurance companies, agencies and agents, and securities firms that, taken together, provide financial services to virtually every household in America.

Given the national and international market for insurance products, the time has come to provide a federal option for the chartering and regulation of insurance firms. The lack of regulatory uniformity, coordination and responsiveness in the state-based insurance regulatory system is unnecessarily costly and burdensome and has resulted in negative competitive implications for insurance companies, insurance agencies, and their customers. The securities and banking industries have long been subject to regulation by the Federal government, which is designed to protect the interests of consumers, regardless of where a product is sold or where the consumer resides. The federal chartering and regulation of insurance firms would extend uniform regulation to all areas of insurance, particularly with respect to products, producers, solvency, and market conduct protections to consumers.

Optional federal chartering and regulation should be based upon the following principles:

<u>The Federal Charter</u>

- *National Treatment* --- Insurers must have the option of obtaining a single charter that would allow them to do business in all jurisdictions.
- *Universal* --- The federal charter must accommodate all lines of insurance and must be equally available to all insurers, regardless of corporate form (stock, mutual or fraternal) or size, and must provide for the federal

chartering or licensing of insurance producers (agents and brokers) and insurance agencies.

- *Convertible* --- Insurers must have an unqualified right to convert both from a state to a federal charter and from a federal charter to a state charter, and a holding company must be permitted to control both a federally chartered and a state chartered insurer.

- *Specialized* --- The federal charter must take into account the inherent differences among different lines of insurance – life, health and property-casualty.

- *Dynamic* --- The federal charter must permit federal insurers to respond quickly to changes in the market place, consumer demands and technology.

The Federal Regulator

- *Single Regulator* --- The federal insurance regulatory authority should be a discrete bureau within the Treasury Department headed by an individual appointed by the President and confirmed by the Senate for a fixed term (on a par with the OCC and OTS).

Federal Regulation and Supervision

- *Financial/Solvency Regulation* --- A federal insurer must be subject to strong solvency regulation and supervision (e.g., capital and reserve levels, investments and accounting).

- *Regulation of Insurance and Forms* --- Federal law should establish an expeditious process for addressing policy forms, which encourages innovation and does not delay the development and marketing of new products. Federal law should rely upon competitive market forces to establish premium rates, rather than government price controls.

- *The Costs of Regulation* --- Federal insurers and producers, not taxpayers, should be responsible for the ongoing costs of federal supervision and regulation.

Consumer Protections

- *Market Conduct Standards* --- Federal insurers and producers must be subject to strong market conduct regulation and supervision.

- *Guarantee* --- Federal insurers and their customers must enjoy the same high level of protection in the event of an insolvency as state chartered insurers and their customers, and the existing insurance guaranty mechanisms must remain in place and accommodate the participation of federal insurers.

- *Antitrust* --- While exclusions from federal anti-trust laws provided by the McCarran-Ferguson Act should not apply to federally chartered insurers, limited safe harbors should be provided for legitimate joint activities.

- *Special Needs* --- Federal insurers should participate in state programs designed to meet the insurance needs of consumers who cannot obtain insurance. Federal insurers also should be free but not required to continue existing investment programs benefiting low and moderate income communities.

Relationship to State Regulation

- *Optional* --- The federal charter must be optional since the availability of a viable state insurance regulatory system is integral to the dual chartering concept.

- *Exclusive Regulation* --- A federal insurer or producer must be regulated exclusively by the federal insurance regulator in all areas defined by statute as being within the jurisdiction of the federal regulator. Conversely, state chartered insurers and producers must be regulated exclusively by state regulators.

- *Taxes* --- Federally chartered insurers must remain subject to the authority of the states to impose premium or corporate income taxes. Choice of charter should not affect the overall state and federal corporate or policyholder tax burdens of individual insurers.

- *Fair Treatment* --- States must be prohibited from discriminating against federal insurers and producers.

STATEMENT

OF

PAUL MATTERA

SR. VICE PRESIDENT & CHIEF PUBLIC AFFAIRS OFFICER

LIBERTY MUTUAL GROUP

ON

INSURANCE REGULATION AND COMPETITION FOR THE 21ST CENTURY

BEFORE THE

HOUSE COMMITTEE ON FINANCIAL SERVICES

SUBCOMMITTEE ON CAPITAL MARKETS AND

GOVERNMENT SPONSORED ENTERPRISES

JUNE 11, 2002

Introduction

Mr. Chairman, Ranking Member Kanjorski, and members of the Subcommittee, my name is Paul Mattera. I am Senior Vice President and Chief Public Affairs Officer of the Liberty Mutual Group. Liberty Mutual is a diversified property and casualty insurance group based in Boston with $14 billion in revenue and over 35 thousand employees in the U.S. and in 15 foreign countries.

I am here today to express our long held belief that state based insurance regulation is fundamentally strong and that the public policy objectives of insurance regulation – to protect consumers by assuring the financial soundness and solvency of providers, promoting competitive markets, and enforcing the insurance laws – can be met best in the context of a modernized state regulatory structure.

Also, I have been asked to discuss the European regulatory model and to consider what lessons might be learned from the EU experience. My views in this regard are informed by the Company's current position as Chair of the International Insurance Council, although my own experience with comparative insurance systems is limited. While Liberty Mutual operates in over a dozen countries, our experience in the European Union is limited to Spain and the UK.

The European Model of Insurance Regulation

The Europeans are attempting to create a regulatory structure that is compatible with the goal of a single EU insurance market. This is an evolving process. While there are certainly lessons for US policymakers, it may be too soon to reach conclusions about the wisdom or need to import such a system.

The first step towards the creation of a single EU insurance market was taken in the mid 1970s with the first set of insurance directives adopting the system known as "host country control." A non-life insurance company domiciled in one member country could operate as a branch or through a subsidiary in any other member country without further licensing requirement. However, the company's activities were regulated by the country in which it conducted business - the so-called host country.

A second set of directives in the early 1990s established the freedom to conduct cross-border insurance. Companies were allowed to write both personal and commercial insurance outside of their country of domicile without having to register their business, but host country control prevailed. Thus, the host country was free to impose its own rate regulation or other regulatory requirements. There was and remains significant variation among the EU countries in the level and intensity of regulation applied.

In the mid 1990s, a third set of directives reinforced the single license concept and the principle of host country control, but abolished rate and product regulation. This means that today companies are free to conduct their business in any EU member country without additional licenses or being subject to rate and product approval. Nevertheless, insurance companies remain subject to the non-rate and form regulations of the countries in which they do business, including local financial, accounting, and tax rules.

While the EU model facilitates the development of a common insurance market in Europe, it has not yet evolved into a unified regulatory system. In the parlance of the debate over federal vs. state regulation in the US, the EU model represents dual regulation with some aspects of a company's operations regulated by the home state, some by the host state, and both subject to the insurance directives of the European Commission.

It is too simple to say, as some do, that the European insurance regulatory system should serve as a model for the US. This is an argument frequently heard from supporters of a federal model. Certainly, aspects of the EU system if adopted in the US would make our insurance markets more competitive. De-emphasis on rate and product approval, re-emphasis on solvency, and ease of multi-state licensure are three notable areas. It is no coincidence that reform initiatives are underway in each of these areas of regulation in the US. Without apologizing for the slow pace of regulatory reform in the US, it should be pointed out that regulatory reform in the EU has taken 20 years, and there is still much to do.

Reexamining the State-Based System of Insurance Regulation

The current system of insurance regulation is under scrutiny by insurance companies, trade associations, consumer groups, agents, regulators, and the Congress. A reexamination is necessary and it is healthy; and so I commend the Subcommittee for holding these hearings.

A modern, efficient regulatory system is essential to meeting the challenges of the 21st century insurance market. These challenges include the emergence of new competitors and competing regulatory priorities associated with the implementation with Gramm-Leach-Bliley, industry frustration with current regulatory practices and resulting inefficient or redundant regulation, the competitive imperatives of e-business, and the economic pressures associated with market consolidation and increasing globalization.

Today's consumers demand efficient delivery of every type of product and service, especially financial services. However, insurance regulation today often impedes the ability of providers to meet their customers' demands. Unnecessary delays, inconsistent treatment, and misplaced priorities frustrate an insurance industry that is simply trying to meet the expectations of its customers.

Let me be very clear: virtually every area of regulation needs to be improved if the state system is to meet the challenges of a modern insurance market. Unlike those who would abandon the state system and start over with federal regulation or dual regulation, Liberty Mutual is committed to doing the hard work in the state capitols necessary to bring about ameliorative change.

Building on Strengths and Correcting Weaknesses

The regulatory modernization agenda of the NAIC and the individual states is well underway. Significant progress is being made in several critical areas of regulation:

- Producer Licensing – 45 states have adopted the NAIC Producer Licensing Model Law which seeks to establish a uniform and reciprocal system for agent licensing. This is something the Congress challenged the states to do in GLB, and the states are responding.

- Company Admission – The NAIC is promoting the so-called ALERT system that facilitates the licensure of companies in multiple states by providing a uniform application and accelerated regulatory review. However, state specific requirements such as seasoning and fingerprinting persist. ALERT should be expanded to encompass a variety of corporate filings such as change in control and related filings. For example, virtually all states have adopted the NAIC Model Holding Company Act, but there are wide variations among the states in the documentation required or review period, making it difficult and expensive to complete mergers or acquisitions where multiple states are involved.

- Speed to Market – There has been significant, but incomplete, progress towards more open and competitive markets, especially in commercial lines such as property, general liability and commercial automobile. But, there is no good reason why any state should retain approval authority over rates or terms of coverage for commercial risks of any type or size, with the possible exception of the very smallest commercial package policies. Progress in personal lines such as auto and home insurance has been slower. Whether or not true rate and form deregulation is possible – practically or politically – in such historically regulated markets as New Jersey and Massachusetts is an open question. However, even in highly regulated markets, greater certainty of filing content and disposition (well established data requirements and adherence to established time frames) would represent significant improvement.

- Market Conduct – NAIC efforts to streamline market conduct examination lags behind efforts to modernize other areas of regulation. Nevertheless, progress is being made and there is every reason to think that a more rational, efficient, and better coordinated system can be implemented.

- Financial Regulation – In some respects, the NAIC's solvency agenda of the early 1990s which established a system of accreditation based on states' adoption of a uniform set of prudential requirements, coupled with uniform risk based capital standards, represents the best of state regulation. There is no reason why the accreditation concept could not be extended to other areas of state regulation.

The Case for State Regulation

State regulation of insurance is a product of our "federal" system of government. Federalism reserves to the states the powers not expressly granted to the central government – and for good reason. As the Founding Fathers believed in 1787, the sovereignty of the states, especially in the areas of the civil and criminal law and the administration of the courts, would become a bedrock principle for our country.

The states have the constitutional prerogative to establish liability systems and similar laws to promote social responsibility. Since insurance is so closely associated with the tort and contract laws of the states, it follows that insurance regulation should remain state-based. For example, liability laws affecting automobile accident reparations, workers compensation, property damage, and personal injury differ from state to state reflecting diverse public attitudes about responsibility and compensation. Insurance products are designed and priced differently in each state to account for these differences. Likewise, our system of contract law is well developed, and with respect to insurance policies is based on more than a century of policy interpretation by state courts.

The best characteristics of the state system including diversity, innovation, and responsiveness would be lost in a federal or national model of insurance regulation. Federal or national models imply a single, uniform set of rules applying equally across all states and all insurance markets. It is difficult to imagine a single regulatory system working in harmony with the diversity of underlying reparation laws and differing public expectations about the role of insurance regulation. For example: Will an open and competitive rating law work in a state with a tradition of subsidizing urban drivers? How responsive will a federal regulator be to market dislocations in individual states caused by extreme weather or seismic activity? Can market conduct be fairly assessed by a federal regulator unfamiliar with the underlying state law or court interpretation?

Implications of Federal or National Regulatory Models

A single federal or national regulatory model implies a rejection of the fundamental notion of diversity and state sovereignty, discussed above. This is an important issue and should be considered carefully by the Subcommittee. Unlike banking or securities, even perhaps life insurance, that have their roots in federal law, property and casualty insurance is inextricably tied to state law. Move insurance regulation to Washington, D.C. and the underlying substantive law will inevitably follow. Does the Subcommittee really want a national workers compensation law or automobile reparations law that ignores local attitudes about responsibility and compensation?

Other attributes of diversity and innovation would be lost in a federal or national regulatory model. Today, the state system reflects a diversification of regulatory risk. In a federal model, regulatory policies would be imposed uniformly on the industry. The advantage of state experimentation and innovation would be lost. For example, the successful open and competitive rating model in Illinois may not have come to pass were the prevailing federal model one of strict prior approval.

Efforts to achieve a federal model are likely to result in dual regulation. For example, Congressional interest in preempting state solvency regulation in favor of uniform financial requirements enforced by a federal insurance regulator may not extend to rate and form regulation. The risk of separating financial regulation from market regulation is real and, if attempted, would present the very worst in dual regulation. Even optional charter proposals invite dual or redundant regulation, and at best add significantly to the cost of regulation by maintaining two separate regulatory systems.

Finally, whatever the inefficiency and ineffectiveness of state regulation – which we would argue does exist but is improving – there is no reason to believe a federal regulatory system would be any better. Critics of both state and federal regulation can point to failures of either system. However, the single largest regulatory failure in recent times was the disastrous failure of the savings and loan industry in the 1980s, costing taxpayers billions of dollars. Neither the federal nor state sector has a monopoly on good financial regulation, but state regulators along with the industry financed guaranty funds are serving insurance policyholders well.

Conclusion

In deciding whether to replace the system of state-based insurance regulation with a mandatory or optional federal model, the Subcommittee should consider the strengths as well as the weaknesses of the current system, should be skeptical of claims that other countries have superior regulatory structures, and should consider ways to encourage the states to undertake a more rapid and comprehensive review and reform. Our current system of state-based insurance regulation is fundamentally sound, but significant reforms are needed if the system is to meet the challenges of a 21st century insurance market.

Thank you.

Statement of

Tony Nicely
Chairman, President & Chief Executive Officer
GEICO Insurance Companies

on behalf of the

National Association of Independent Insurers

before the

House Financial Services Capital Markets, Insurance and Government Sponsored Enterprises Subcommittee

June 11, 2002

The National Association of Independent Insurers appreciates the opportunity to present its views on insurance regulation and competition in the insurance industry.

It is an honor to share my views on several important issues affecting the insurance industry and the millions of stakeholders whose private or business life is in some way touched by insurance. The Subcommittee's deliberations and conclusions will have implications for individual insurance consumers, insurance investors, the business community, the insurance industry and its regulators, and countless other stakeholders. We commend you for taking the initiative to learn more about these subjects and I offer the support of my company and the NAII as the Subcommittee continues its research.

I address the Subcommittee in my capacity as Chairman of the Board of Governors of the National Association of Independent Insurers (NAII) and as the chief executive of the GEICO Group of property-casualty insurance companies. The views I will share with the Subcommittee are based on my own business experience over 40 years in the industry, and the perspective of the NAII, a 700+ member company trade association that was founded in 1945 after Congress enacted the McCarran-Ferguson Act. Since that time NAII has supported the McCarran-Ferguson Act, which reserved the role of insurance industry oversight to state government on the principle that insurance markets in which competition is the primary regulator of rates best serves consumers.

GEICO is the largest direct marketer of insurance products, the fifth largest private passenger auto insurance company, and the 10th largest property-casualty insurer in the United States.

GEICO has assets of $10.6 billion, employs 18,000 associates and protects more than 4.7 million policyholders and over 7 million automobiles.

GEICO's commitment to customer service, efficiency and financial stability makes us a major stakeholder in the effort to modernize and enhance the state regulatory system. I have taken the time to personally visit with insurance regulators and the National Association of Insurance Commissioners (NAIC) in recent months to discuss ways to update and strengthen the state regulatory system. I am convinced that the states are up to the challenge of improving the regulatory system.

NAII is one of the nation's largest full-service property-casualty insurance trade associations, representing the most diverse membership. NAII's membership accounts for $98 billion in annual premiums, comprising 31 percent of the industry's total property-casualty premium volume and 43.9 percent of the total personal lines market. Member companies range in size from billion-dollar national companies to multi-line regional groups to single-state and niche/specialty writers. They include mutuals, stock companies, surplus line carriers, and reciprocals: all the traditional corporate insurance structures. In fact, NAII represents the broadest cross-section of insurers of any national trade organization. NAII members transact most types of property-casualty insurance, use every type of distribution system, and have experience operating under the regulatory environment in each of the 50 states. The diversity in membership is one of the association's greatest strengths and provides NAII with a unique perspective on insurance regulation. Since the bulk of our membership consists of smaller personal lines oriented companies, NAII is very qualified to speak on behalf of the unique needs and local markets that those insurers serve.

The NAII membership is distinguishable by the diversity in business models and markets, yet the companies all share the same common vision that competition and market-oriented regulation is in the best interest of the industry and the customers they serve. NAII's express mission is to foster a competitive insurance marketplace, which not only promotes the successful operation of its members, but enhances the welfare of their customers.

Nearly 60 years after its founding, the NAII – more than any other trade group in the industry – still firmly believes in the concept of competitive markets, and advocates regulatory principles that make competition thrive.

GEICO and NAII support the state regulation of insurance and oppose federal involvement in the regulation of the insurance business. However, we agree with the vast majority of insurers, agents, regulators, state legislators, and Members of Congress that the insurance regulatory system must improve. We recognize that support for state insurance regulation is dependent in large part on the willingness of the states to institute meaningful reforms to modernize regulation so that it reflects the way our business is conducted today and so that it will be adaptable to the way we will conduct business in the future. We strongly urge Congress to give the states ample opportunity to improve the state regulatory system to meet the concerns that have been articulated in these hearings and in legislative and regulatory proceedings in state houses across the nation. NAII is deeply committed to working with the National Association of Insurance Commissioners, individual state regulators, state legislators, and all other interested parties to improve the state regulatory system. However, until the momentum for regulatory modernization takes hold in the states, NAII is ready to evaluate with an open mind all proposals offered to enhance the regulatory system.

As the committee considers the future of insurance regulation, we have been requested to present our views on financial regulation and examinations, solvency, auditing requirements, accreditation programs and data sharing, as well as our views on regulatory modernization.

Solvency Regulation

Solvency monitoring is the most important aspect of state regulation. Insurance is a promise that the insurer will make a future payment in the event of a covered loss. Solvency regulation's role is to make sure that the insurer is financially able to keep that promise but security cannot be the only goal of regulation. NAII strongly believes that the benefits to the public of a free and competitive marketplace are as important as the security of the insurance promise itself.

Accordingly, NAII believes that the objective of regulators should be to balance the interests of security and free enterprise. There will always be insurer insolvencies in a free market economy. The primary regulatory objective is not to eliminate all insolvencies, but to minimize their costs in terms of dollars and human suffering. It is this balance that NAII believes is essential in the financial regulation system. While the current state system does not achieve a perfect balance, it is improving and there are steps underway to improve it further.

The overall record of state insurance regulation in preventing insolvencies in the last ten years has improved, as measured by individual company failures, as compared to the five-year period just before and just after the House Energy and Commerce Committee's "Failed Promises" congressional report. According to data reported by the A.M. Best Co., during the years 1987-

1991, 203 property-casualty insurers became insolvent, an average of 40.6 per year. During the period 1992-2001, a period which includes both the effects of Hurricane Andrew in Florida and the recent Reliance insolvency, a total of 214 companies became insolvent, an average of 21.4 per year. As A.M. Best points out, "Since 1994, insolvency rates for the property-casualty industry have generally stabilized. A. M. Best attributes this trend, in part, to competition in the market, which has encouraged healthy insurers to rescue ailing insurers before they become insolvent . . . In addition, regulatory oversight has improved while many states have increased their capital requirements."

It is true that the Reliance insolvency was the failure of a major national insurer, and its full effects cannot yet be measured. It should also be noted, however, that the tragic events of September 11, 2001, which caused the largest insured loss in history, are not expected to cause the insolvency of a single U.S. insurer. We think that this is testimony to the general success of the state solvency regulatory system.

The last time that state regulation of insurance was seriously called into question was when the House Energy and Commerce Committee issued its "Failed Promises" report on the Mission and Transit insolvencies in 1989. This report challenged the ability of state regulators to regulate large, multi-state insurers. Since that time the NAIC, state insurance departments and the insurance industry have undertaken many significant improvements in the state financial regulatory system. Among these improvements are:

- Financial Regulation Accreditation and Standards program (Adopted in 1990)
- Audited financial statements (Adopted in 1989, effective in 1991)
- Risk-based capital (Adopted in 1993 for both life and P/C insurers)
- Model Law on Examinations (Adopted in 1991)
- Investments in Medium and Lower Grade Obligations Model Regulation (Adopted in 1991)
- Codification of statutory accounting principles (Effective 2001)

There is certainly no guarantee that federal regulation or an optional federal charter approach would improve insurance solvency regulation. Federal regulators have failed to prevent major financial institutions from failing. The savings and loan industry meltdown during the late 1980s was a national scandal and cost U.S. taxpayers billions of dollars. Even today, major depository institutions fail despite regulatory oversight from multiple agencies. The recent Superior Bank failure illustrates this point. The federal insurance regulator under an optional federal charter system would not have any greater operational knowledge than state regulators with respect to financial oversight. And the state regulatory system has demonstrated an ability to respond promptly when circumstances warrant as was the case a decade ago when the NAIC's Accreditation Program was adopted and implemented. Our judgment is that state regulation in this area is improving, and that its past performance does not warrant federal intervention.

NAII was asked to share its insights on how solvency regulation works in practice. Under state regulation, solvency regulation can be divided into four major functional areas: (1) financial reporting; (2) financial analysis; (3) financial examination; and (4) corrective action. Since they don't fit neatly into any of these baskets, we will take up investment regulation and reinsurance separately.

As we discuss these issues, it is imperative that policymakers keep in mind that financial regulation at the state level is a comprehensive and complex process developed over many years. Significant changes in the system of the type that might occur as the result of federal encroachment should not be undertaken lightly – their potential to disrupt a system that has worked well over the years is significant.

The Basis of Authority for Financial Regulation

Insurers are subject to strict financial regulation by the states. Each state's statutes give its insurance commissioner (or similar official) the responsibility and power to regulate the financial condition of the insurers licensed to do business in that state. There is significant similarity, however, in these statutes. Almost all states have adopted, either through statute or regulation, the financial regulation requirements in the NAIC Financial Accreditation Standards program. Among other requirements, this includes incorporating (generally by reference) the NAIC's annual and quarterly financial statements, accounting manual, auditing and actuarial requirements, risk-based capital and examination model laws. Thus the NAIC is a very significant actor in the financial regulation process, not as a regulator but as a forum for regulators to develop standards that are incorporated generally in each state's statutes.

Financial Reporting

Financial reporting consists of how insurers keep track of their own financial condition and operating results and disclose such information to regulators, investors, policyholders and the public in general. This requires an accounting system and a standard reporting format.

Accounting Practices and Procedures Manual

In theory, insurers could use GAAP (Generally Accepted Accounting Principles), the accounting system used by all publicly-traded corporations in the United States. Indeed, publicly traded insurance companies use GAAP for their financial statements to shareholders and investors. Insurance regulators, however, believe GAAP's system of income and liability recognition is not conservative enough for the purpose of determining whether an insurer has sufficient assets to pay its claim liabilities to policyholders.

Since the early 1900s, state regulators through the NAIC have maintained their own accounting system, commonly known as "statutory accounting principles" (SAP). Each insurer must use statutory accounting to file its financial statements with the state regulators in the states in which the insurer is licensed to do business. SAP is primarily focused on the needs of regulators to assure solvency, rather than the needs of investors for information relevant to an entity's future performance. In a gross oversimplification, SAP differs from GAAP in that it recognizes liabilities earlier and/or at a higher value and recognizes assets later and/or at a lower value. For these reasons, companies will generally show higher surplus and earnings under GAAP than under SAP.

Statutory accounting has just undergone a major revision, called the "codification of statutory accounting principles," ultimately published as the NAIC's new *Accounting Practices and Procedures Manual*. The new Accounting Manual, which became effective January 1, 2001, is significantly more comprehensive than prior SAP and should provide much more comparability in insurer financial statements. The guiding principles of the manual are "conservatism, consistency and recognition," and, while it has grown closer to GAAP, the accounting manual remains significantly more conservative.

Annual and Quarterly Statements

The NAIC also produces a standard Annual and Quarterly Statement that the great majority of insurers are required to file with, in the case of the Annual Statement, all of the states in which each insurer is licensed. The Annual Statement is also filed with the NAIC, and is used to populate the NAIC's financial database, which is available for use by all states. The Annual Statement is a far more comprehensive financial statement than normal GAAP statements. For example, along with including a balance sheet, income statement and cash flow statement, the Annual Statement contains an extensive schedule showing the history of how company loss reserve estimates have varied (developed) over time, and another schedule that contains separately-reported data on each security that the company owns. The Quarterly Statement is a more limited statement that provides basic financial data on a quarterly basis, and is also filed with the NAIC if a company is licensed in a state that requires the filing.

Audited Financial Statement

All but the very smallest insurers are now required to have their annual statutory financial statements audited by an independent certified public accountant. The NAIC's Model Regulation requiring Annual Audited Financial Statements is one of the NAIC's Financial Accreditation Standards, and is also part of the Annual Statement Instructions, which are incorporated by reference in all states. The audited financial statements include the balance sheet, statement of operations, statement of cash flows, statement of changes in capital and surplus, and notes to the financial statements.

Actuarial Opinion

The Annual Statement Instructions require nearly all property-casualty insurers to include with the statement the opinion of an actuary or otherwise qualified person as to whether the company's loss and loss adjustment expense reserves make a "reasonable provision" for the company's future claim and expense liabilities. Since, unlike general businesses, the great majority of an insurer's costs are incurred after its revenues are received, insurance accounting requires companies to establish reserves for claims and claim-related expenses as the claims are incurred, generally at the insurer's estimate of the ultimate cost of those claims and expenses. Since loss and loss expense reserves are by far the largest liabilities on an insurer's balance sheet, their accuracy is critical. Since they involve the estimation of future events, however, they cannot be exact. Therefore, review by an actuary or individual with similar expertise is necessary. The Actuarial Opinion and Actuarial Report (the proprietary material that backs up the Opinion) are used by regulators to analyze whether the insurer's reserves are adequate.

Financial Analysis

Once a company has filed its financial statements with the states in which it does business and the NAIC, regulators need to be able to analyze what the statements mean and whether they indicate that a company is in good financial health or needs help. Following are several tools that state regulators use in this process.

IRIS ratios

The Insurance Regulatory Information System (IRIS), which is part of the NAIC's Financial Solvency Tools (FAST, discussed further below), has often been called the "Early Warning System." Its purpose is just that, to alert regulators to developing problems early enough for them to take effective action. For property-casualty insurers, IRIS consists of a series of 12 financial ratios, for which ranges of "normal" results have been calculated. These ratios are aimed at several different concerns, including capital adequacy, changes in business patterns, underwriting results, reserve inadequacy and asset liquidity. It is not unusual for a company to have abnormal results for one or two ratios, but regulatory interest is increasingly attracted the higher the number of abnormal results. After the ratios are generated, a team of state financial examiners and analysts prepares confidential reports analyzing each company's results and ranking them in terms of increasing danger of insolvency to aid state regulators in giving the proper financial analysis and examination priority to each company.

FAST ratios

The FAST system also includes other ratios focusing on profitability, asset quality, investment yield, affiliate investments, reserves, reinsurance, liquidity, cash flows and leverage. Higher FAST scores suggest a greater danger of insolvency. These confidential results provide another tool for state regulators to use in prioritizing companies for their attention.

Risk-Based Capital

Each state's statutes prescribe a minimum level of capital and surplus for insurers writing particular types of business in the state. In the early 1990's the NAIC questioned the adequacy of these statutory standards and developed a system that prescribes capital requirements corresponding to the level of risk of the company's various activities. The result was the NAIC's separate risk-based capital (RBC) formulas for life, property-casualty and health insurers. Each formula applies separate RBC "charges" for an insurer's asset risk in affiliates, asset risk in other investments, credit risk, underwriting risk, and business risk. In doing so the formula establishes a hypothetical minimum capital level that is compared to a company's actual capital level to develop a ratio. Another part of the RBC system is the Risk-Based Capital Model Law, which is an accreditation standard and has been adopted in all but one state. The Model Law sets four levels of required company and/or regulatory action, ranging from the Company Action Level (for companies with RBC ratios between 150 percent and 200 percent, where the company must develop a plan to raise its RBC ratio) to the Mandatory Control Level (for companies with RBC ratios below 70 percent, where the domestic regulator must place the company either into rehabilitation or liquidation).

While the RBC system is intended to prescribe minimum capital levels, regulators also expect it to function as an early warning system, with decreasing RBC ratios over time indicating a higher danger of insolvency.

Financial Analysis Working Group/NAIC Financial Analysis Division

This group of regulators and the NAIC staff division that supports it focus on the financial condition of "nationally significant insurers," defined as companies that write business in 17 or more states and write more than $30 million in gross premiums. This process, which is confidential, provides regulatory peer review of the actions domiciliary regulators take to improve the financial condition of larger insurers.

Financial Examination

The final method that regulators use to determine a company's financial condition is the financial examination. The NAIC's Model Law on Examinations, adopted in essence by nearly every state, requires each state's insurance department to conduct an on-site examination of each company domiciled in that state every three (in older versions of the law) or five years. These examinations are to be conducted according to the NAIC's Financial Condition Examiners Handbook, an extensive compilation of schedules, procedures, outlines and other guidance. According to the Handbook, the purposes of the examination system are "(1) Detecting as early as possible those insurers in financial trouble and/or engaging in unlawful and improper activities, and (2) Developing the information needed for timely, appropriate regulatory action." Within the confines of the five-year limit, regulators are encouraged to prioritize examinations of companies that are in the most troubled financial position, and the NAIC also provides a Troubled Insurance Company Handbook to help prioritize these companies and prescribe actions.

States can conduct either full-scope or limited-scope examinations. Full-scope exams are extremely thorough, and can encompass review of the company's management and internal controls, plan of operation, corporate records, accounts, financial statements, business in force, loss experience, reserves, asset quality and reinsurance. It is not uncommon for full-scope exams to take several months to a year or more to complete. The basis of the current full-scope exam is verification that the company's balance sheet as of a particular date is correct. A limited-scope exam usually focuses on one or more aspects of a company's operations, and may be called if financial analysis indicates regulatory concern in a particular area.

Corrective Action

Once a state regulator determines that a company's financial condition is endangered, state statutes provide regulators with broad authority to require companies to take corrective action. The final sanctions include the state's ability to rescind the company's license to do business or, if the company's condition warrants, to take control of the company or to liquidate it. Another accreditation requirement is that a state must have adopted in substance the NAIC's Model Regulation to Define Standards and Commissioner's Authority for Companies Deemed to be in Hazardous

Financial Condition. This regulation provides standards for regulators to use in determining whether an insurer is in hazardous financial condition, and sets forth a list of actions the insurance commissioner may take or require such a company to take. These include steps such as requiring the company to reinsure more of its business, reduce or suspend the volume of new or renewal business, divest itself of certain investments or discontinue particular investment practices, and filing additional financial reports.

Investment and Reinsurance Regulation

Two important areas of financial regulation that do not fit neatly into the four functions described above are regulation of insurer investments and reinsurance.

Investment Regulation

As compared to general corporations, insurers hold a far higher percentage of their assets in securities, real estate, mortgages and other investments. This is because an insurer's primary business involves holding funds provided by policyholders to pay future claims and expenses. An insurer must invest those funds until they are used to pay claims. It is obviously critical to solvency that an insurer invests those funds in assets of high quality (to protect solvency) and that also produce a reasonable return (to reduce costs to insureds). Those assets should also be reasonably liquid, and the insurer's portfolio should be diversified.

Each state has a fairly detailed investment law that specifies which types of assets domestic insurers may hold. Many of those laws also prescribe limits on the amounts of each type of asset that an insurer may hold, as well as limits on the amount of investments in a single issuer that an insurer may hold. The NAIC has also drafted two model investment laws that states may either adopt in whole or in part when they feel the need to modernize their investment laws. One model law is designed for use by states whose laws prescribe limits for most asset types (the so-called "pigeonhole" model), and the other is intended for states whose laws rely more on the manner in which insurer management conduct their investment policy (the so-called "prudent person" model). A separate NAIC model, the Investments in Medium Grade and Lower Grade Obligations Model Regulation, limits the amount of non-investment grade obligations in which an insurer may invest.

Statutory accounting principles also contain the concept of "admitted assets", which are intended to be readily convertible into cash in order to pay claims. Generally, the limits in state investment laws provide that, to the extent a company's investments exceed the limits, they are "nonadmitted" and the company cannot take credit for them on the Annual Statement's balance sheet.

Finally, companies must value their investments correctly. Under the NAIC's accreditation standards, each accredited state must require that securities be valued according to the rules of the NAIC's Securities Valuation Office (SVO), and that other invested assets be valued according to the rules of the NAIC's Financial Condition (E) Committee. The SVO is a NAIC staff office that assigns asset quality designations (NAIC-1 for the highest quality, through NAIC-6 for obligations in default) and valuations.

Reinsurance Regulation

A final piece of the regulatory structure is regulation of how companies reinsure their liabilities. This is also critical to the primary company's solvency, since generally if a reinsurer becomes insolvent, the primary insurer remains liable to its insureds with respect to business it has reinsured. The NAIC and the states addressed this concern through the accreditation process by enacting the NAIC's Model Credit for Reinsurance Act. This law provides standards for when companies can reduce their unearned premium or loss reserve liabilities or take credit for reinsurance recoverable as an admitted asset. Companies may take credit for reinsurance from reinsurers that are licensed or accredited in the ceding company's domestic state. These reinsurers have submitted themselves to the domestic state's regulatory authority. If the assuming company is unaccredited, the ceding company may take credit only if the assuming company maintains a U.S. trust fund or acceptable, segregated collateral or a letter of credit in at least the amount of the ceding company's liabilities.

Regardless of whether the reinsurer is accredited or unaccredited, primary insurers have their reinsurance portfolio monitored by regulators via the Annual Statement and the financial examination process. There is great detail about a primary insurer's reinsurance program set out in the various parts of Schedule F of the insurer's Annual Statement. Additionally, the general interrogatories of the Annual Statement also include information about the reinsurance program of the insurer.

Finally, in order to more fully assure that funds are available to pay claims in the event of an insolvency of the primary carrier, for a primary company to obtain credit for reinsurance, the reinsurance agreements must contain a provision that the reinsurance is payable by the assuming insurer on the basis of the liability of the ceding insurer under the contracts reinsured without diminution because of the insolvency of the ceding insurer.

From this it is clear that, absent licensing in a state, a reinsurer generally is not regulated directly. Insurance regulation has taken a market-based approach to effectively regulate the reinsurer in the context of regulating the primary insurer. Without reinsurance meeting certain qualifications, the primary insurer cannot obtain credit for the reinsurance. This allows for numerous alternatives to secure that credit, as the insurer sees fit and finds available in the marketplace. It also permits insurers to find reinsurance to strengthen their financial position regardless of the credit for reinsurance, if that insurer so chooses.

Improvement Needed

The NAII and others in the industry have been critical of several aspects of state financial regulation in recent years. We believe that portions of the regulatory system are unnecessarily costly and inefficient. There has been a tendency to "layer" new reporting, analysis and examination tools on top of existing procedures without determining what procedures are now unneeded and can be eliminated. There are indications that the NAIC and the states are beginning to respond. Two new NAIC groups, the Risk Assessment Working Group and the Examination White Paper Focus Group, have been created to respond to regulatory and industry concerns that the financial examination system needs to be improved. Although there are no guarantees, we are working with these groups to eliminate costly inefficiencies in the examination process, and to refocus the examination so that it is not exclusively balance sheet oriented but evaluates how management is assessing and dealing with future business and other corporate risks. The objectives are to lessen the intrusiveness of the financial regulation process and increase its effectiveness in minimizing the financial impact of insolvencies. We continue to believe, however, in state regulation. The states have responded and we believe that our efforts to work with the states to improve the process will yield positive results.

NAIC Accreditation Program

One of the reasons why GEICO and NAII continue to believe in state regulation is because it has responded in the past when challenged. For instance, the NAIC's Financial Regulation Standards and Accreditation Program is a testament to the resilience of the state system. In response to an unprecedented wave of insurer insolvencies in the late 1980s, state regulators and the NAIC responded by crafting and implementing a program designed to enhance solvency regulation. It was based on the premise that each state should have minimum criteria or standards (laws, regulations, implementation and personnel practices) for monitoring solvency. Under the NAIC's accreditation system, a state must have enacted each model law, regulation and practice specified in the program in order to receive "certification". Examples of "Part A" of the accreditation standards include the NAIC Model Insurance Holding Company System Regulatory Act, Model Law on Credit for Reinsurance, and Model Rule Requiring Annual Audited Financial Reports.

"Part B" of the standards comprises regulatory practices and procedures relating to implementation of the "Part A" standards. NAIC and the states sought to assure that each jurisdiction not only had the requisite statutes and regulations in place, but that they were interpreting and enforcing them appropriately. Further, "Part C" of the standards seeks to assure that each jurisdiction has met minimum standards for organizational and personnel practices relating to the solvency regulatory function.

Every state has adopted most of the accreditation requirements, and all but two states are currently certified.

The Accreditation Program has been a clear success in that it met the two original goals of 1) improving state regulation for solvency, and 2) helping to defuse the call for federal solvency regulation prevalent in the early 1990s. At a minimum, the Accreditation Program has assured that states meet a baseline of solvency regulatory standards.

In the years since establishment of the original standards, the NAIC working in conjunction with state legislators continues to refine the Accreditation Program, carefully adding newer solvency regulatory tools to keep pace with evolution in the marketplace. Recently added standards include the modified NAIC Accounting Practices and Procedures Manual (more commonly known as "codification"), and the model rule requiring annual audited financial reports.

Following consultation with groups of state legislators including the National Conference of State Insurance Legislators (NCOIL), the NAIC in 1998 created a revised process for adding new standards to the program. The system helps assure flexibility, including addition of new standards if there is true consensus the given model, provision or practice can effectively enhance solvency regulation. The process includes procedural safeguards and opportunity for input from all interested parties.

The NAII has commended the NAIC for crafting the Accreditation Program, and state legislators for adopting the legislative standards where necessary. The Accreditation Program serves the U.S. insurance-buying public well. The key to the Program's adoption in the states lies in the true underlying consensus among state legislators and regulators regarding the need for solvency regulatory reform. Our hope is that similar underlying consensus will grow among state policymakers regarding the need for modernization of other aspects of state regulation, especially those pertaining to rates and forms, market conduct, and licensing procedures.

Adoption of these new standards or tools does not prove by itself that state solvency regulation has improved. Nevertheless, the pace at which the NAIC developed and states implemented the requirements of the accreditation standards does show, however, that the states can react quickly when sufficient need is shown.

Safety Net - State Guaranty Funds

While financial oversight is arguably the most important role of regulators over financial institutions, the reality is that banks, savings and loans and insurers will, on occasion, fail. This scenario can arise, regardless of whether an institution is regulated by a single regulator or multiple regulators as in the case of banks (by the Federal Reserve, the Comptroller of the Currency, and the Federal Deposit Insurance Corporation (FDIC).) Since there have been periodic failures in the insurance business, the "safety net" function of the state guaranty funds is critical.

Our observations are exclusively in reference to property-casualty insurance guaranty funds. These funds have been in existence since the late 1960s in all states. Above all else, it must be said that guaranty funds have consistently fulfilled their role as guarantors of payment when an insurance company fails. They are largely inconspicuous claim payment and financial assessment mechanisms. In just over 30 years, the funds have paid out over $9 billion in claims, often under crisis-like conditions due to multiple failures over a short time period or because of major natural disasters. For example, in the mid-eighties, the insolvencies of six insurers meant guaranty fund payouts totaling over $2.5 billion. Hurricane Andrew devastated south Florida and other states in 1992 generating insured losses exceeding $15.5 billion, yet while the Florida guaranty fund was strained due to a spate of insolvencies, covered claims were paid. Hurricane Iniki in 1993 destroyed an estimated $1.6 billion in property in Hawaii, yet could not bring down the Hawaii guaranty fund. Indeed, the state guaranty funds have "weathered many storms" and adapted to very difficult situations.

State guaranty funds operate in accordance with local statutory provisions, with coverage terms varying somewhat depending on the state. They are tailored to the insurance market conditions of each state. So, appropriately, states may set differing caps on fund payments. Generally these caps are $300,000 per claim or higher, with no cap on workers' compensation. Compare that to the $100,000 cap the FDIC administers in conjunction with federally insured deposits.

When an insurer is declared insolvent and ordered liquidated by a court, the guaranty funds step in and act like the insurer, processing and paying claims. Claim payments are subject to state laws which outline procedures such as the time to file claims (bar dates) and other payment limitations (for example, net worth of the insured/claimant, unearned premium amounts, punitive damages). More significantly, claim payments are handled subject to the terms of the policy the insolvent insurer issued, with variances relating to company, state statutes, local conditions, state tort and state contract law. Guaranty funds differ from the FDIC in that the former entities do not merely replace funds that were maintained in an account. Rather, guaranty fund operations are about the processing of insuring claims swiftly, but prudently, so as to prevent fraud and identify claims without merit. This explains why the insurance industry has a hands-on role in administering state guaranty funds.

Insurance industry involvement is also appropriate because private insurance companies are assessed to provide the capital or cash flow for the guaranty funds. Insurance company officers and legal staff are frequently on the boards of state guaranty funds, providing guidance to state fund managers. Generally, state guaranty funds do not assess insurers until a need for funds materializes. This "post-assessment" system helps insurers maintain the capital needed for their own investment and claim payment. Additionally, unlike the banking industry where the FDIC is pre-funded to meet immediate cash needs of depositors, guaranty funds, like any property-casualty insurer, do not pay until there is a determination that a claim is covered. In addition, claim payment is often not immediate due to a pending legal action. This "lag" permits a post-assessment system to work.

Currently, the annual assessment capacity of state guaranty funds (on a countrywide basis) is over $4 billion and growing. In the 30-plus years of state guaranty funds, the largest annual capacity utilization was under 35%. Since property-casualty insurance claims are often spread out over a number of years, this moderates the immediacy needs of guaranty fund assessments. For example, some of the insolvencies of the mid-1980s still have claims outstanding.

Since 1969, property-casualty insurer insolvencies have averaged 14 a year. This rate of insolvency should be weighed in the context of the number of firms in the industry. According to the NAIC, in the year 2000, there were over 3,200 property-casualty insurance companies licensed in the U.S.

State guaranty funds are one aspect of the state system of regulation that has worked extremely well over their history. NAII is very skeptical of any federal intervention that would abolish or modify the state guaranty fund system. For instance, an optional federal charter bill that establishes federal standards for state funds or a standby federal guaranty fund in the event of a state failing to match federal requirements would be of great concern. These measures would undermine state coverage terms and rules that were developed to match local market conditions, and they could threaten the assessment capacity of the state funds if companies chartered at the federal level were exempted from assessment at the state level.

Insurance Data

Data reporting and availability is one element of insurance regulation that is especially important to NAII and its member companies. A substantial number of NAII members are small property-casualty writers. These companies operate as single-state insurers, or regional writers that transact business in a limited number of states. Because of smaller books of business, these companies are not able to develop actuarially credible rating information through their internal loss experience alone. They depend on the availability of aggregated industry loss cost data in order to develop rates. Without advisory loss cost data, smaller insurance companies would be unable to compete with larger companies that are able to rely on their own loss experience to develop accurate rates.

In addition, many property-casualty insurers (both small and larger, regional companies) rely on the availability of supplemental rating information developed by licensed advisory organizations such as the Insurance Services Offices (ISO) in order to administer their rating programs. This advisory information would not be available if all insurance companies did not report data or were constrained from reporting data as the result of federal antitrust law exposure. On the other hand, if it were available at all, the cost might be prohibitive because the statistical agent organizations that collect, aggregate and publish data would have fewer companies over which to spread their production expenses.

The state regulatory system respects the value of advisory loss cost and similar data to insurance market competition by (1) compelling insurance carriers to report data; and (2) authorizing the compilation/publication of such data by licensed advisory organizations. This data contains key information regarding insurance coverages and recent premium and loss experience related to such coverages. Laws and regulations in all states require insurers to report statistical data, and state insurance regulators use statistical data for a variety of purposes. For example, the data helps regulators analyze trends in loss experience under various types of policies, and evaluate the appropriateness of rates and rating plans being used in their states. In most jurisdictions the regulators appoint statistical agents to perform the data collection function, and NAII serves as a statistical agent. The NAIC Statistical Handbook specifies the content of the reports that these statistical agents produce. The statistical agents in turn develop more detailed statistical plans that are continuously reviewed and updated as necessary.

The McCarran-Ferguson Act provides another essential statutory provision in respect to the availability of advisory data. The Act's limited antitrust exemption provides the legal framework under which statistical agents for the state can collect data, and insurance companies can pool and use aggregated loss information. Under the current statutory and regulatory framework at the state level, all insurers regardless of size must report relevant loss experience. This pooling of data allows regulators to carry out their functions and also provides insurers with sufficiently credible data to assure the ability to compete on price. Advisory loss cost data has helped to maintain a blend of both large national firms and small community level and regional underwriters in the property-casualty insurance markets.

In response to various proposals over the years that could have altered the limited antitrust exemption and the permissibility or requirement for all companies to report data, NAII has consistently pointed out the linkage between advisory data availability and competitive insurance markets. In the absence of such data, smaller insurers would confront increased operating expenses, due to data acquisition expenses or less competitive pricing. Over time, it could threaten the small company franchise. The absence of data would also have a chilling effect on the ability of some insurers to expand into new markets or new product lines, or perhaps to continue in current markets.

If an optional federal charter system made data reporting discretionary or abolished the McCarran Act antitrust law safe harbors, many companies would be forced to either do business with less accurate pricing or to restrict underwriting. The statistical reporting framework currently in place in the states facilitates and enhances competition. A number of studies including those by the U.S. Justice Department, state insurance departments and respected economists consistently conclude that the insurance industry is very competitive under classic economic tests.

If insurers chartered at the federal level were exempted from mandatory data reporting requirements (either explicitly in the legislation or post-enactment through a preemption of state law by a federal regulator), the ability of rate advisory organizations to develop credible rating information tools could be jeopardized. The current statistical data collection and pooling system, effectively overseen by state regulators and the NAIC, serves regulators, industry and consumers well. Regulators are afforded insightful statistical information to help them carry out their regulatory functions. Through the required reporting of statistical data by all insurers, companies and the consumers they serve enjoy the benefits of enhanced competition and wider availability of coverage.

Regulatory Modernization

Changes in the economy, globalization of markets, new technologies, and convergence in the financial services industry in recent years have spurred demands for regulatory reform and modernization. NAII has in fact taken the lead in calling for a number of significant changes at the state level. Demands for change have also been echoed at the federal level and there are currently two comprehensive bills being discussed in Congress calling for the creation of an optional federal charter regulatory system.

Virtually all segments of the insurance industry see the need for insurance regulatory improvements, but no single solution is supported across the board. Certain segments of the industry favor a single, centralized regulator, others support adoption of federal standards, while a large segment proposes further improvements to the state system.

In the post September 11 insurance environment, there has been significant interest in whether the property-casualty insurance industry will be able to absorb multiple financial hits of the size of the World Trade Center disaster. Much debate has taken place over the last six months on whether Congress should enact a high level federal financial backstop over private sector insurance coverage in the event of future terrorism losses. If regulators and lawmakers are concerned about future underwriting capacity in the private insurance market, they should work to assure that the insurance regulatory system is structured so as to encourage the natural infusion of private capital into the industry. Regulatory rules, procedures and philosophies should be geared toward stimulating market competition, not impeding it. For example, there are over 1,400 companies writing automobile insurance in the U.S., however, only 350 of those companies on average write auto insurance in any given state.

If an industry's regulatory system is oppressive, inefficient, or bureaucratic, it will discourage investment and venture capital from entering that industry. That at least partly explains why much of the new capital coming into the insurance sector subsequent to 9-11 has gone to offshore enterprise. Regulation, whether based at the state or federal level, must be market-oriented and based on the premise of competition, the free enterprise system, and assure an adequate return on equity.

Similarly, the regulatory system must provide a means through which layers of risk can be redistributed efficiently, including to the capital markets. This is especially critical today as our society learns that risks such as terrorism and large natural disaster events have the potential to generate huge claim losses that can drain significant financial capacity out of the private insurance industry. As a result, regulatory modernization should include the requisite corporate structural authority for underwriters and investors to partner in risk securitization transactions. Regulators and lawmakers should be interested in setting policies in insurance and tax laws that encourage greater access to capital markets, long term reserving for terrorism and other disasters, and new investments in the insurance industry.

GEICO and the NAII agree there is reason for, and room for, change in the insurance regulatory framework. GEICO believes that state regulation can and should be given the opportunity to respond to the call for change, and so does NAII. We strongly believe that states must be given ample opportunity to make needed changes to their regulatory systems and are deeply committed to working with the NAIC, individual state regulators and legislators, as well as Congress, to encourage reform.

GEICO and the NAII continue to support the state regulatory system. First and foremost, insurance markets are local in nature. Property-casualty insurance products and the regulatory systems reflect significant variances in state laws relating to tort liability-injury compensation rules, contract standards, motorist obligations, the role of government, and for that matter, local variances in social and economic values. For instance, some states have elected to have a third party tort liability system govern personal injury reparations. Insurance laws and coverage therefore follow those statutory standards. In contrast, other states have opted for a comprehensive, no-fault auto insurance plan, and accordingly, insurance contracts must be structured along first-party and third-party lines. Because of the economic disparities (as manifested by variances in per capital income levels), law- makers in some states have chosen more modest financial responsibility limits, low cost auto insurance programs or created uninsured motorist waivers. These factors help explain why state regulation is the "best fit" insofar as insurance markets are concerned. State regulation has served, and continues to serve, as the foundation for competitive insurance markets, which afford consumers the greatest choice among service providers, pricing options, and insurance products.

State level supervision also encourages regulatory experimentation. While a bad regulatory policy at the state level can hurt local market conditions, at the national level it could disable the entire market. Some states are willing to correct regulatory systems that no longer work or have hurt competition.

While our trust in state regulation remains solid, both GEICO and NAII realize that the state system must undergo reform. Current regulatory systems in some states cause delays in introduction of new products and slow rate approvals. In some states, the company and agent licensing processes are lengthy and cumbersome. Conversely, in other states, the market withdrawal process is both bureaucratic and punitive in nature. Financial and market conduct examinations are often disjointed and inefficient, and suffer from a lack of coordination. These areas of state regulation must be updated, simplified, and greater uniformity must be achieved among the states.

Fortunately, a number of regulators are beginning to take action to address these problems. A number of states have initiated the process of enacting reciprocal agent licensing laws. Congress expressed its concern over this issue during debate on Gramm-Leach-Bliley and the states have taken steps to address the concerns. A number of states have enacted reforms in recent years that have significantly simplified the product and rate approval requirements for some commercial line contracts.

The NAIC commitment to regulatory reform has been encouraging also. For instance, the NAIC has identified procedural reforms that can simplify or expedite some aspects of regulatory compliance (e.g., Uniform Regulation Through Technology program) and have shown interest in procedures that can improve "Speed-to-Market" time. They have also put some regulatory concepts on the table (e.g., the Coordinated Advertising Rate and Form Review Authority, Interstate Insurance Compact for Multi-state Life Products, etc.) that evidence a willingness to engage the industry in a dialogue on regulatory modernization.

It is thus too soon to dismiss state regulatory modernization. Furthermore, we think it premature to doubt the sincerity of state officials to embrace change and take action. Congress must give the states time to move forward.

Although we believe it premature for congressional intervention, congressional attention to these issues may prove instructive. For instance, the congressional spotlight could encourage state regulators and the NAIC to reassess their reform agenda and self-critique the sufficiency and swiftness of the response to date. If Congress is sending a message by its actions, let it be that the states need to make their reforms more robust, that reform must extend to additional states, that reform must incorporate more product lines (including personal and main-street business lines), and that the pace of reform should quicken.

Federal Intervention – The Optional Federal Charter

GEICO and NAII are deeply committed to working with the NAIC, individual insurance commissioners, state legislatures, and other stakeholders on improvements to modernize the state regulatory system. While working with the states on regulatory improvements, we are also analyzing all other proposals for regulatory reform. Until such time as regulatory modernization has taken hold in all states, our industry must be ready to evaluate proposals advanced by others for improving insurance regulation. It is in this context that NAII is studying the optional federal charter system, including the two Congressional proposals.

The optional federal charter plans that have appeared so far envision a very ambitious but complicated regulatory system. They contemplate two separate regulatory regimes – one at the federal level, one at the state level – which ideally would foster regulatory competition between federal and state supervisors. In theory, such competition would yield more modernized and efficient regulation in the most critical areas, including rates and forms, market entry/exit, and company examination. In addition, a federal charter could be attractive to companies operating on a multi-state basis if regulatory compliance involved adherence to one set of standards administered at the federal level, rather than varying standards administered by several states.

The plans present interesting suppositions and theories, but to rush into a new system without thoroughly examining the consequences would be shortsighted. Both GEICO and NAII have apprehensions over the premature abandonment of exclusive state regulation without a full examination of the effects on the industry and consumers.

First and foremost, insurance regulatory reform is highly complex. The industry is extremely diverse. While the banking system has a dual charter structure, banking is an entirely different business franchise than insurance, and that industry's ties to our nation's monetary system and the economy provide a compelling justification and historical basis for federal oversight. There is however no comparable, intrinsic justification for a federal role in insurance oversight.

When it enacted the McCarran-Ferguson Act in 1945, Congress recognized the complex nature of insurance and concluded that the industry should be regulated at the state level. Unless the states prove themselves unworthy of retaining their exclusive role as insurance regulators, we urge Congress to refrain from intervention.

Second, the proposals raise issues for consumers, policyholders, and taxpayers as well as insurers themselves. In its analysis of optional federal chartering legislation, NAII has identified 10 major areas that present significant complexities and challenging public policy issues. For example:

- Optional federal charter systems that replicate state standards at the federal level will merely duplicate the shortcomings of the state system. This approach is evidenced by the treatment of rate and forms in federal bills. As a result it is difficult to see how a federal system duplicating the problems of the state system could result in regulatory competition or improvements on the state system.
- Current legislative proposals fail to establish explicit standards for acquiring a federal charter and could result in an unlevel playing field for certain insurers, particularly single state or niche writers. Unless all bona fide insurance companies regardless of their size, business plan, or method of delivery have a legitimate opportunity to acquire a federal charter the regulatory advantages under the federal charter could undermine market competition. A highly competitive market provides the greatest benefit to consumers. As a result, it is difficult to appraise the workability and practicality of an optional federal charter plan if critical regulatory standards are not enumerated.
- An optional federal charter system that precludes, restricts, or even discourages the production of advisory loss costs and supplementary rating information could seriously undermine competition and place smaller and regional firms at a disadvantage. Proposals for optional federal charters would alter the McCarran-Ferguson Act antitrust safe

harbor provisions that currently allow data sharing. They would also weaken state data reporting mandates. The inability of small companies and regional market firms to access needed data could significantly impair their ability to compete.

- An optional federal charter system that results in overlapping or dual regulation would significantly increase the cost of doing business. Financial or market conduct oversight at both the federal and state levels would needlessly drive up operating costs, and insurer solvency could be jeopardized.
- An optional federal charter system that established a national solvency fund for federally chartered companies could impair the financial capacity of state insolvency funds.
- An optional federal charter system that did not specifically authorize corporate structural flexibility and mobility between charters could result in unlevel playing fields. Even if insurance firms were given the regulatory flexibility to adjust their corporate structure in relation to their chartering needs, some companies would accrue significant, new business costs (e.g., setting up holding companies, demutualizing, acquiring a federal charter) to remain competitive under an optional federal charter system.
- An optional federal charter system that incorporates market-based regulation at the federal level for some business lines but not others would create "winners" and "losers" with adverse affects on market conditions and consumer choice.

Enacting and implementing a comprehensive optional federal charter that avoids serious design flaws would be a lengthy and Herculean task. The stakes are high and the pitfalls numerous. If Congress inadvertently failed in any of these critical areas, the resulting damage to market competition would harm consumers and further delay necessary reforms.

A Report Card on State Modernization

The states have been slow to embrace needed regulatory reforms that benefit all types of property-casualty insurers. NAII was encouraged several years ago when legislators in South Carolina repealed a number of laws that had prevented automobile insurance companies from competing aggressively in the state. By virtue of the state actions, that auto insurance market is undergoing staged regulatory re-engineering, and the benefactors will be local consumers who will eventually have more choices and more competitive insurance pricing. There are indications that the number of companies writing auto insurance has doubled in the few short years since the regulatory reforms were enacted (1999). More consumers in South Carolina will be insured by private insurance companies rather than involuntary market pools/facilities. NAII remains optimistic that South Carolina regulatory reforms will serve as a catalyst for similar actions in other states. What is especially significant about South Carolina's actions is that they affected personal lines insurance underwriting.

Legislative reform affecting personal lines insurance in 2002 however was minimal. One state enacted a law calling for a study of the insurance rating system. The New Jersey General Assembly is considering measures to reform their insurance regulatory system. The reforms would include a more competitive rating system. If New Jersey enacts regulatory modernization, it could spur action in other states with significant insurance markets.

For commercial lines, it is anticipated that by the end of 2002 approximately three states will have adopted some statutory changes, and most of these follow through on prior reforms. For example, the South Carolina Legislature has made it easier for businesses to be insured under streamlined risk placement and rating rules. New Mexico and Michigan are in the process of adopting commercial reforms, refinements of earlier legislative activity.

NAII and other industry groups have engaged individual regulators and the NAIC in a continuing dialogue on regulatory modernization over the last several years. These interactions resulted in the NAIC launching several "speed-to-market" initiatives and developing a regulatory concept for expediting product and price review (the NAIC's Coordinated Advertising Rate and Form Review Authority or CARFRA Program). While both sides still disagree on some of these measures, ideas have been exchanged. The dialogue has included exploratory discussions with regulators in a number of states on the prospect of moving from prior approval rating to competitive rating principles, and in correcting insurance department practices that slow the filing and approval process. These efforts have produced a number of operational reforms at the NAIC and a commitment from several individual insurance departments to reevaluate their rate and form filing procedures.

As NAII noted in its congressional testimony last summer before this Subcommittee, the NAIC's Improvements to State-Based Systems Working Group in 2000 produced a number of operational suggestions that, if individual state regulators adopted, would expedite the process of product approval somewhat. Those suggestions include elimination of desk-drawer rules, and specific timeframes for action by insurance departments on proposed rate and form changes. Individual state insurance departments must take the initiative to adopt procedures that enhance operational efficiencies and make certain they are implemented and adhered to by their staff.

To gauge the level of operational changes in the various insurance departments, the NAIC is moving toward a system of "self-certification" by the departments. Feedback from NAII members and others in the industry thus far indicates that the depth and breadth of the NAIC reforms and state regulatory implementation has not gone far enough. It is clear that the NAIC and state regulators will need more time. NAII has encouraged members of the NAIC to work more closely with legislators in their own states to help achieve the more important statutory reforms. Thus far, the NAIC has yet to take definitive action on recommendations to the states for statutory reforms affecting personal lines. Operational (insurance department) reforms will have a marginal effect at best if they are implemented in a state with an anti-market statutory framework for rate/form regulation.

Conclusion

We trust Congress will give the states more time to make meaningful advancements in their statutory and regulatory systems for commercial and personal lines insurance. Ongoing oversight by this Subcommittee can help impress upon the states the importance of improving and modernizing state insurance regulation. States need to understand that non-action in this area will only encourage federal intervention and potentially the abdication of their role as regulators-policy setters. On the other hand, if states move forward with regulatory modernization in a more aggressive manner, there will be renewed confidence in state regulation. There will also be a payoff to consumers, investors, and other stakeholders as property-casualty insurance markets become more competitive than they are today.

Thank you for the opportunity to present the views of GEICO and the NAII.

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TESTIMONY OF FRANKLIN W. NUTTER, PRESIDENT

REINSURANCE ASSOCIATION OF AMERICA

INSURANCE REGULATION AND COMPETITION FOR THE 21ST CENTURY

BEFORE THE CAPITAL MARKETS, INSURANCE AND GOVERNMENT SPONSORED ENTERPRISES SUBCOMMITTEE HOUSE COMMITTEE ON FINANCIAL SERVICES

June 11, 2002

CHAIRMAN BAKER AND MEMBERS OF THE COMMITTEE:

My name is Franklin W. Nutter and I am president of the Reinsurance Association of America (RAA). The RAA is the nation's leading trade association representing the US property/casualty reinsurance industry. RAA members are licensed, authorized or accredited in all US jurisdictions. I am pleased to appear before you today to address reinsurance matters, particularly those regulatory matters that affect the competitiveness of the US reinsurance industry in this very global marketplace. I am not here today to advocate one system of regulation over another, but instead, as you requested, to point out several issues of great importance to US reinsurers and to give you our views on how those issues should be addressed, regardless of the regulatory method that is employed. The issues I plan to address are credit for reinsurance, extraterritorial application of state laws, mutual recognition and insurance receiverships.

I. BACKGROUND ON REINSURANCE

a. The US Reinsurance Market

Before I begin with my remarks about those issues, I want to provide you with a brief overview of the reinsurance market and how reinsurance regulation is conducted in the United States.

Reinsurance is a transaction in which one insurance company indemnifies, for a premium, another insurance company against all or part of the loss that it may sustain under its policy or policies of insurance. The insurance company purchasing reinsurance is known as the ceding insurer; the company selling reinsurance is known as the assuming insurer, or, more simply, the reinsurer. Described as the "insurance of insurance companies," reinsurance provides reimbursement to the ceding insurer for losses covered by the reinsurance agreement. The fundamental objective of insurance, to spread the risk so that no single entity finds itself saddled with a financial burden beyond its ability to pay, is enhanced by reinsurance.

Reinsurance is a key component of the insurance marketplace, reducing the volatility experienced by insurers and improving insurers' financial performance and security. It is widely recognized that reinsurance performs at least four primary functions in the marketplace: to limit liability on specific risks; to stabilize loss experience; to protect against catastrophes; and to increase insurance capacity.

The increasingly important role that reinsurance plays in the insurance marketplace cannot be over-emphasized. Industry statistics show that the net reinsurance recoverables on all paid and unpaid property/casualty losses in 2000 represent approximately 144.2 percent of the surplus of US property/casualty insurers.[1]

Reinsurance is a global business which can be best illustrated by the number of reinsurers assuming risk from US cedents. In year 2000 more than 3,300 foreign reinsurers assumed business from US ceding insurers. Those reinsurers were domiciled in more than 100 foreign jurisdictions.[2]

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[1] BEST'S AGGREGATES & AVERAGES PROPERTY-CASUALTY UNITED STATES (A.M Best Co., ed. 2001); According to the NAIC Annual Statement Instructions for Property/Casualty insurers, property/casualty lines of business, include: fire, allied, farmowners multiple-peril, homeowners multiple-peril, commercial multiple-peril, mortgage guaranty, ocean marine, inland marine, financial guaranty, medical malpractice, earthquake, group accident and health, credit accident and health (group and individual), other accident and health, workers' compensation, other liability, product liability, auto liability, auto physical damage, aircraft, fidelity, surety, burglary and theft, boiler and machinery, credit, and international of the foregoing lines.

[2] REINSURANCE ASSOCIATION OF AMERICA (RAA), ALIEN REINSURANCE IN THE US MARKET 2000 DATA (2000), at 3.

b. US Reinsurance Regulation – Direct and Indirect

The US employs two methods of reinsurance regulation, both direct regulation and indirect regulation.

Direct regulation is imposed on those reinsurers that opt to be licensed in the US. Reinsurers licensed in at least one US jurisdiction are subject to the full spectrum of laws and regulations to which a primary insurer is subject. The exceptions to this general rule are rates and forms. Because reinsurance is conducted between sophisticated parties of essentially equal bargaining power, regulators do not impose regulatory requirements relating to the rates that can be charged for reinsurance or the forms that can be used to evidence the contractual terms.

US licensed reinsurers are subjected to regulation that requires, among other matters, the following:

- Minimum Capital and Surplus Requirements
- Risk-Based Capital Requirements
- Investment Restrictions
- Disclosure of Material Transactions
- Licensing (fit and proper) Requirements
- Disclosures/Prohibitions on Certain Fronting Transactions
- Obligations/Prohibitions with Respect to Reinsurance Intermediaries
- Asset Valuation & Requirements
- Examinations of the Reinsurer
- Insurance Holding Company Requirements
- Fraud Prevention
- Annual Statement Mandated Disclosures, Accounting and Filings
- Credit for Reinsurance
- Unfair Trade Practices
- Annual Independent Auditor's Reports
- Actuarial-Certified Loss Reserve Opinions
- Restrictions on Assumption Reinsurance Transactions

Recognizing that an insurance marketplace as large as that found in the US is in need of a substantial amount of reinsurance capacity, US regulators do not prohibit non-US reinsurers from assuming reinsurance business in the US, nor do they presume to have the regulatory capability or resources to assess the financial strength or claims paying ability of non-US reinsurers.

Instead, the US has developed a system of indirect regulation whereby the reinsurance transaction is regulated through the credit for reinsurance mechanism. Credit for reinsurance is the financial statement accounting effect given to a ceding insurer if cessions are ceded in accordance with prescribed criteria. If the criteria are met, the ceding insurer may record a reduction in insurance liabilities for the effect of the reinsurance transactions. The fundamental concept underlying the US regulatory view is that a reinsurer must either be licensed and subject to the full spectrum of reinsurance regulation or provide collateral to ensure the payment of the reinsurer's obligations to US ceding insurers.

In taking this regulatory approach, the US has created a very open but secure marketplace. The system is also grounded on a level playing field. All options for doing business in the United States whether it is through licensing, accreditation, multiple or single beneficiary collateralization – are open to all reinsurers whether they are domiciled in the US or elsewhere in the world.[3]

II. KEY ISSUES FOR THE US REINSURANCE INDUSTRY

There are a number of important elements about reinsurance regulation with which RAA members are concerned. I will address a few of them today.

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[3] US credit for reinsurance laws provide a number of options for non-US reinsurers that seek to assume reinsurance risk from US ceding insurers. A non-US reinsurer may:

1. Obtain a license to conduct insurance/reinsurance in the US by establishing a separate affiliate entity or by directly "entering" the US through a particular state and establishing a branch in the US;

2. Establish a multiple beneficiary trust which secures its obligations to all US cedents plus a surplus amount which is, for an individual assuming insurer, US $20 million (for Lloyd's the joint and several surplus amount is US $100 million); or

3. Provide individual collateral (through a trust, letter of credit or other acceptable security) to each of its ceding insurers without the necessity of a surplus amount in addition to its obligations.

a. Credit for Reinsurance

US laws providing for the circumstances under which ceding insurers may take financial statement credit are the cornerstone of US reinsurance regulation. Those laws are based in substantial part[4] on the NAIC model law and regulation governing credit for reinsurance.[5]

The NAIC model law and regulation have been the subject of debate in recent years. Non-US trade associations are currently advocating the reduction of collateral for those reinsurers that choose not to be subjected to US reinsurance regulation. Advocates of this reduced security claim that US collateral requirements impede competition and are unnecessary in a world that is becoming more global. The RAA and US primary insurers have opposed this effort at weakening US regulation and diluting the financial security of US insurers and their policyholders.

As the world's largest insurance marketplace, the US is dependent on non-US as well as US reinsurance capacity. At the same time, US regulators cannot be expected to know, or to learn, the intricacies of accounting systems and regulatory schemes used throughout the world to determine the financial strength of non-US reinsurers. Because the ceding insurer is allowed financial statement credit for cessions to such non-US reinsurers, it is imperative that US regulators have the confidence that the non-US reinsurer is able and willing to pay its obligations to US ceding insurers as they become due. This is accomplished through the collateralization of the reinsurer's obligations. Collateralization eliminates the regulator's need to assess the level of regulation in the non-US reinsurer's domiciliary jurisdiction or the financial strength of the particular reinsurer. Collateralization ensures that funds are available to satisfy the non-US reinsurer's obligations

[4] There are significant deviations among the states, particularly in the area of extraterritorial application of state laws as discussed in subsection b. of this section.

[5] CREDIT FOR REINSURANCE MODEL LAW, Vol.-785 (National Association of Insurance Commissioners 1996) and CREDIT FOR REINSURANCE MODEL REGULATION, V-786 (National Association of Insurance Commissioners 1996).

whether it is solvent or not.

Non-US reinsurers have all the options available to them for doing business as do US domiciled reinsurers. In taking this approach, the US has struck a proper balance between creating and maintaining an open marketplace while ensuring the financial security of ceding insurers and their policyholders. It is difficult to comprehend how the US system impedes competition when one considers the number of non-US reinsurers that assume business from US insurers.[6]

The RAA believes that it is essential to maintain the strong regulatory structure that has been created in the US. The NAIC model and regulation for credit for reinsurance represents a minimum regulatory threshold for protecting the financial interests of US insurers and their policyholders. This minimum threshold should be maintained if not improved as the states work on improving their regulatory environment. If Congress were to consider an optional federal charter, the RAA would urge Congress to incorporate a strong credit for reinsurance regulatory system similar to the NAIC model and regulation.

b. Extraterritorial Application of Law

The RAA recognizes the need for greater efficiency in the regulation of reinsurance. As a result of our 50-state system of regulation, significant differences have emerged among the states with respect to reinsurance regulatory requirements. The cost associated with addressing these deviations among the states, in addition to the basic expense of a multi-state system, add extra costs to transactions that are ultimately reflected in the premiums paid by consumers. While the NAIC and state regulators are to be applauded for their efforts toward greater uniformity in the adoption of model laws and regulations and the creation of the accreditation system, this has not prevented

[6] *See* RAA, *supra,* note 2, at 3 and 14. US reinsurance companies accounted for 53.4 percent of the US premium written in 2000, while non-US companies accounted for 46.6 percent.

states from pursuing varying and sometimes inconsistent regulatory approaches. One of the best examples of this phenomenon is the extraterritorial application of state laws.

Approximately 14 states apply at least some of their regulatory laws on an extraterritorial basis, meaning that the state law not only applies to the insurers domiciled in that state but to insurers domiciled in other states if the extraterritorial state has granted a license to the insurer. Many insurers and reinsurers are licensed in all states. An insurer domiciled in a state other than New York but licensed in New York will find that New York law applies to the way it conducts its business nationwide. This extraterritorial application of state law results in inconsistencies among state laws.

States applying at least some of their laws extraterritorially include: California, Colorado, Florida, Kentucky, Maryland, Michigan, New Jersey, New Mexico, New York, Oregon, Pennsylvania, Texas, Utah and West Virginia.

As Congress proceeds in reviewing the current regulatory structure and considering a new one for the future, we should focus on streamlining reinsurance regulation to be more competitive in the global marketplace. Any structure that is adopted should eliminate duplicative and inconsistent regulation like that which is caused by the extraterritorial application of state laws.

c. Mutual Recognition

As I have previously mentioned, reinsurance is a global business. It has long been recognized that the level of reinsurance regulation varies substantially in countries throughout the world. The United States, which imposes a very highly structured level of regulation upon licensed reinsurers stands in stark contrast to countries like Belgium where reinsurers are subject to no direct reinsurance supervision and Greece where reinsurers are subject to no supervision whatsoever.[7]

While some countries impose what has been characterized as "equal or nearly equal treatment" of "professional" reinsurers[8] and direct insurers,[9] other countries employ a "reduced regime" of direct supervision,[10] and still others combine some elements of direct supervision with indirect supervision.[11] This summary of the level of reinsurance regulation was derived from the results of a questionnaire submitted by the EU Commission to member countries and published in 1999.[12] As noted by other commentators, the results not only reflect the diversity of reinsurance regulation in the EU alone, but the fact that there is no globally recognized method of conducting reinsurance regulation.[13]

There is an effort underway in several forums, including the NAIC, IAIS,[14] and through the WTO financial services negotiations, to create a system of mutual recognition among countries. This effort, led by European trade associations, seeks to establish a system where a country recognizes the reinsurance regulatory system of other countries and allows reinsurers to conduct business without the additional imposition of regulatory requirements. If such a system

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[7] GESAMTVERBAND DER DEUTSCHEN VERSICHERUNGSWIRTSCHAFT & BRITISH INSURERS' INTERNATIONAL COMMITTEE, DRAFT FRAMWORK FOR A EUROPEAN REGIME FOR THE SUPERVISION OF CROSS-BORDER REINSURANCE, at Enclosure A (1999).

[8] The term "professional reinsurers" is used here only for clarity since the term has been used in the references cited. It is not typically used in the U.S.

[9] Denmark, United Kingdom, Finland and Portugal. *See* GESAMTVERBAND DER DEUTSCHEN VERSICHERUNGSWIRTSCHAFT & BRITISH INSURERS' INTERNATIONAL COMMITTEE, *supra,* note 5.

[10] *Id.* Austria, Italy, Spain and Sweden.

[11] *See id.* Germany, France and the Netherlands.

[12] *Id.,* at 2.
[13] *Id.*

[14] The IAIS is the International Association of Insurance Supervisors which is comprised of insurance regulators from over 100 jurisdictions.

were established, European reinsurers would be permitted to assume reinsurance risk in the US without having to obtain a US license and without having to provide collateral for their liabilities to US ceding insurers. This would be the result even if the European reinsurer was domiciled in a country with far less reinsurance regulation than that which is imposed by US regulators on US licensed reinsurers.

The RAA has challenged this effort for several reasons. Although US reinsurers recognize the value of a more efficient reinsurance regulatory system, mutual recognition cannot be accomplished on a worldwide basis, or even a regional basis, until certain other events occur.

First, there needs to be created and implemented, an international accounting system, which provides more transparency between different existing systems. That effort, though underway, is years from becoming a reality.

Second, there must first be mutual recognition among the states within the US. It makes no sense whatsoever for regulators to place trust and confidence in the regulatory systems of foreign jurisdictions before and until they afford that trust and confidence to their counterparts in the US.

Third, there needs to be established a predictable and consistent method for the recognition and enforcement of US judgments abroad. The RAA recently submitted a paper to the NAIC on this subject which demonstrates that while the US regularly recognizes and enforces the judgments rendered in other nations, US judgments are often not given reciprocal treatment. The US is not a party to any treaty for the recognition and enforcement of judgments and some European countries refuse to recognize or enforce judgments with such jurisdictions. Other European countries refuse to enforce punitive damages and treble damages while still others review the fairness of compensatory damages in light of their own public policy.

And finally, any level of foreign regulation, which is mutually recognized by the US, must become the new cap for the level of regulation imposed by US regulators on US licensed reinsurers. There is no legitimate rationale for imposing a higher level of regulation on US reinsurers than that which US regulators are prepared to accept from those who are regulated abroad.

There are differences in the insurance markets throughout the world. In some countries, there are only a few companies that assume reinsurance risk while thousands of reinsurers assume reinsurance risk ceded by US insurers.[15] While the RAA does not seek to export the US reinsurance system to those countries where few reinsurers assume risk, it does advocate the need for substantially the same level of regulation to be imposed if those reinsurers want to assume business from the US on a mutual recognition basis.

d. Receivership

Insurance companies, like any other commercial enterprise, are subject to financial failure. Unlike individuals and many commercial entities, insurance companies are not subject to US bankruptcy laws. Instead, insurance company receiverships are administered on a state-by-state basis. While the nature of insurance companies that become insolvent has changed over the years, state receivership laws have failed to keep up with those changes and are now generally outdated and inadequate to handle the administration of large sophisticated entities.

Most state receivership laws are based on prior NAIC models and attempts to update state laws with the current NAIC model have failed. The reason for those failures is due, in large part, to the controversial nature of the model and circumstances under which it was drafted and

[15] See RAA, *supra*, note 2, at 3 and 14. While more than 3,300 non-US reinsurers assumed risk in 2000, those reinsurers accounted for less than half of the reinsurance premium written that year.

adopted. Therefore, the outlook for improving state receivership laws through adoption of the current NAIC model law is bleak.

Reinsurers are keenly interested in receivership laws because reinsurance recoverables are oftentimes the largest asset in the estate of an insolvent insurer. Issues such as priority, setoff, arbitration, cut-throughs, insolvency clauses, claim estimation/acceleration, and voidable preferences dominate the litigation involving reinsurers and insolvent estates. State laws with respect to the matters are both deficient and inconsistent.

Several years ago, the Insurance Receivership Interstate Compact Commission appointed a group of receivership experts from state insurance departments, guaranty associations, and the insurance and reinsurance industry in an effort to develop a better quality and more balanced receivership law. That effort resulted in the Uniform Receivership Law (URL), which has the support of a number of regulators, receivers and industry associations.

The RAA supports the creation of a uniform national receivership system to replace the current system. The administration of impaired and insolvent insurance companies should be fast, efficient and predictable. Toward this end, the RAA supports the adoption of the URL on a national basis and believes it represents the best chance that we have for achieving the uniformity, equity and predictability that creditors are entitled to expect and receive from government.

III. CONCLUSION

The world is changing--at a fast pace. The way in which reinsurers do business is changing, the products and services they offer is evolving, the range and characteristics of their competitors and their clients is expanding. Reinsurers have been in the forefront in anticipating these changes and in advocating greater regulatory efficiencies to expand their opportunities in a global marketplace.

Technology, global events, convergence of financial markets combine to offer regulators the opportunity to effect fundamental change to the insurance and reinsurance regulatory regimes that have existed in the past. However, this opportunity carries with it the burden of ensuring that the critical balance between efficiency and financial security is reached.

The United States has an open reinsurance marketplace, as illustrated by the substantial participation of non-US reinsurers. At the same time it is a highly regulated environment that places solvency first and foremost, including the collectability of reinsurance recoverables.

The RAA has long been an advocate for strong reinsurance regulation. US reinsurers have seen the problems of past insolvencies when weak players entered and exited the marketplace, leaving the stronger reinsurers with harsher regulation imposed on them in an attempt by regulators to avoid a repetition of past mistakes. That stronger regulation is accompanied by a higher cost of doing business which is borne not by the weak players that exited the market but by the long-term players that were not the cause of the problem in the first instance. Strong reinsurance regulation is at best a deterrent to the entry of such marginal reinsurers in the marketplace and, at worst, a means of detecting the weak players at an earlier stage.

Ceding company clients suffer from the absence of strong reinsurance regulation.[16] To the extent that reinsurance recoveries are unavailable due to the reinsurer's insolvency, or such recoveries are made less efficiently and more expensively, guaranty associations are unable to recoup the funding they provide to policyholders and claimants. The primary insurance industry bears that loss and the cost of business is increased, resulting in higher costs to the consumer.

[16] Insolvencies in the US are administered by the insurance departments and, to a large extent, policyholders and claimants are paid by guaranty associations. Guaranty associations are funded by the solvent insurance industry.

The RAA is not here today to advocate one regulatory structure over another. We urge the Subcommittee to consider, in its deliberations, the importance of maintaining strong regulation through credit for reinsurance laws, proceeding cautiously toward mutual recognition, improving the insurance receivership process, and eliminating duplicative and inconsistent reinsurance regulation. There are a number of alternatives available for the future structure of insurance and reinsurance regulation, but regardless of the method pursued, it is incumbent upon us to ensure that the critical balance between efficiency and financial security is maintained.

The RAA thanks Chairman Baker and the Subcommittee for this opportunity to comment on insurance regulation and competition in the 21st century, and we look forward to working with all Members of the House Financial Services Committee as the Committee considers this most important issue.

STATEMENT OF THE AMERICAN INSURANCE ASSOCIATION

Testimony of Robert P. Restrepo, Jr.
President and CEO of
Allmerica Property & Casualty Companies, Inc.
On behalf of
The American Insurance Association
on
Insurance Regulation and Competition for the 21st Century
before
the Subcommittee on Capital Markets, Insurance
and Government-Sponsored Enterprises of
the House Financial Services Committee
U.S. House of Representatives

June 11, 2002

American Insurance Association

The American Insurance Association is a national
trade organization of property and casualty insurers.

PROFILE

The American Insurance Association is a full-service trade organization of property and casualty insurance companies. In its present form, the association combines three earlier organizations. One of those, the former National Board of Fire Underwriters, was organized in 1866, making it one of the oldest trade associations in the nation.

The various departments provide members with up-to-date intelligence on legislative, regulatory, judicial and technical developments relating to our industry. The AIA also maintains liaison with insurance regulators, federal and state lawmakers, other state and federal government officials, insurance and non-insurance industry groups and media—supplying information and assistance on issues of mutual concern.

A countrywide system of regional offices and local legislative counsel ensures prompt and rigorous attention to property and casualty insurance matters. At the same time, technical specialists from disciplines as diverse as law, economics and engineering educate members and outside publics on developments that may affect the industry and its services to the insurance-buying public.

TESTIMONY OF ROBERT RESTREPO
BEFORE THE SUBCOMMITTEE ON
CAPITAL MARKETS, INSURANCE, AND GOV'T SPONSORED ENTERPRISES
OF THE HOUSE FINANCIAL SERVICES COMMITTEE

JUNE 11, 2002

Thank you Mr. Chairman.

My name is Robert Restrepo, and I am the President and CEO of Allmerica Property and Casualty Companies, located in Worcester, Massachusetts. Our two flagship property/casualty insurance operations are Hanover Insurance Company and Citizens Insurance Company of America.

Allmerica ranks 23rd among all property/casualty insurers in the U.S. Our business, balanced between personal and commercial lines, is written predominantly in the Northeast and Midwest regions of the country. Although Allmerica is not one of the giants of the insurance industry, we are strong supporters of comprehensive insurance regulatory modernization, including optional federal chartering.

I am here today on behalf of the American Insurance Association, which represents over 412 major insurance companies that provide all lines of property and casualty insurance and write more than $87 billion annually in premiums. I serve as AIA's incoming Chairman, and also participated in the task force that developed AIA's regulatory reform agenda.

I appreciate the opportunity to testify this afternoon about the insurance regulatory system both in the U.S. and abroad and, in particular, AIA's support for optional federal chartering as a way to make the current state regulatory system more effective and efficient for all stakeholders.

Insurance industry mergers and acquisitions, convergence of the various financial services industry sectors, globalization, technology, and, most recently, the tragic terrorist attack of September 11 each have had a tremendous—and very different—impact on our industry. The cumulative effect of these events and changes has been an almost total overhaul of the operating environment in which we conduct business. Yet, the insurance regulatory environment has remained largely unchanged since 1945, when the McCarran-Ferguson Act established the principle of Congressional deference to state insurance regulation. Our industry stands out as one of the most heavily regulated sectors of the U.S. economy, in marked contrast with other financial sectors that are under this Subcommittee's jurisdiction.

For every incremental movement toward greater state regulatory efficiency or uniformity, there are many new state-specific regulatory requirements that result in cost, delay, and frustration for insurers—with minimal, if any, consumer benefit. AIA fully supports continued efforts to modernize and improve the state regulatory system, and we continue to work to that end. However, we also believe that federal regulation is an option that should be made available to insurers and their customers. Regulatory reform, including optional federal chartering, will benefit the insurance mechanism as a whole and, in particular, the individuals, families, and businesses who rely on property/casualty insurance products for short- and long-term financial security. We commend the Subcommittee's focus on this topic as part of your broader examination of insurance regulation in the post-Gramm-Leach-Bliley era.

The Current State Regulatory System

The current state regulatory system imposes significant costs on insurers and, ultimately, our customers, as well as the economy at large. These costs arise because statutes and regulations are not uniform, and also because, in many states, inefficient and/or inequitable regulatory actions prohibit insurers from appropriately responding to marketplace changes.

While our antiquated regulatory system remains in place—substantially hindering our ability to adapt and better serve our customers—the legal and economic environment in which we operate is changing at breakneck speed. If the insurance industry cannot keep up, the economy suffers because insurance underpins and provides much-needed security for businesses and individuals to innovate, invest, and take on risk. The bottom line is that consumers ultimately will pay more, for less adequate risk protection, than would be the case under a more dynamic regulatory system.

The current state regulatory system is a jumble of individual state requirements. Individual state insurance codes provide dozens of different rate and form regulatory requirements for the various lines insurance. Uncodified practices of many state insurance departments, known as "desk drawer rules," impose additional, often needlessly onerous, procedural requirements. One problem that this causes in the marketplace is that companies wishing to launch a national product cannot do so until it has been separately approved in every state where they wish to offer the product.

The current fifty-state regulatory system imposes significant direct and indirect costs, including:

- higher compliance costs associated with non-uniform regulations and multiple enforcement requirements;

- complex corporate structures needed to accommodate unique regulatory regimes;
- delayed implementation of new products and pricing changes, due to multi-state regulatory delays; and,
- less competition due to entry, exit, price, and product approval barriers that have been erected in numerous states.

The National Association of Insurance Commissioners ("NAIC") has acknowledged the need for a more efficient regulatory system. Over two years ago, the NAIC launched a new regulatory modernization effort, dubbing the rate and form regulatory reform project "speed to market." Indeed, the "speed to market" label aptly describes a key goal of all participants in the regulatory process—to make available new products, at the right price, as quickly as possible.

AIA has been working closely with the NAIC and individual state legislators and regulators to promote speed to market initiatives across the regulatory system as a whole, as well as in each of the states. The NAIC has produced a white paper and, more recently, a model rate and form regulatory reform statute. These recommendations move in the right direction, but ultimately fall short of a true market-based approach. Unfortunately, the pace of change at the state level has lagged even farther behind. Changes that have been made are not uniform. As a result, property/casualty insurers still face a patchwork system of regulatory approvals that imposes significant costs and delays, without concomitant consumer benefits. AIA remains committed to the state reform process, but we urge Congress to move forward with the creation of an optional federal charter.

International Considerations

Any assessment of the U.S. regulatory system must be done in a global context, given the increased role of insurance in the world economy and the increased number of global insurers. Over the last decade, primarily through the 1997 World Trade Organization (WTO) Uruguay Trade Round, many major insurance markets around the world have undertaken significant reforms in how their markets are regulated, changes that have consistently resulted in more open, modern and competitive regulatory regimes. Countries are embracing these reforms because of their vast benefits to their economies and to provide consumers there with higher levels of consumer choice and service. In fact, the U.S. has encouraged and advocated these reforms in various trade arenas and is in the process now of making significant insurance market-opening requests of all of the 145 member countries of the WTO as a part of the new world Doha Trade Round. These negotiations, expected to be concluded in 2005, are expected to result in more insurance regulation reforms and market openings in many countries.

While the U.S. should continue to play a leadership role in seeking insurance reforms around the world, it should also address the shortcomings of its own system in an effort to make our system more efficient and competitive. Insurers and consumers alike all over the world will benefit from open and competitive markets that give consumers ready access to needed products at competitive prices. If the U.S. licensing system poses barriers to entry in our market, as some of our trade partners believe (the European Union and Japan specifically), we should address these barriers and seek to make our system as competitive as it can be in this larger global marketplace context. As other countries modernize their regulatory regimes, a failure by the U.S. to modernize our own system will threaten our global competitiveness and reduce our credibility in seeking additional reforms abroad on an ongoing basis.

Need for an Optional Federal Charter

We believe that optional federal chartering will benefit consumers and boost the competitiveness of the insurance industry. We recognize that you have heard from several witnesses who oppose any federal involvement in the regulation of insurance. However, there are a number of compelling reasons for Congress to move forward with optional federal chartering, including:

Rapid change has altered all aspects of the insurance mechanism, except its regulatory structure: Over the past five years, changes stemming from financial services modernization, globalization, and technology have changed the insurance system more dramatically than during the first fifty years since the McCarran-Ferguson Act established the principle of Congressional deference to state insurance regulation. The pace of state-based regulatory improvements has not kept up with the needs of insurers and the customers they serve.

A level playing field is critical to the long-term viability of the insurance industry: The Gramm-Leach-Bliley Financial Modernization Act changed the rules of competition for insurers, banks, and securities firms. A level regulatory playing field is essential for insurers who need to compete in this environment. The dual charter (which is similar in concept to optional federal chartering) model has served the needs of banks and their customers for over a century and now deserve serious consideration as an alternative for insurance.

New technologies do not countenance state-specific regulatory barriers: The Internet and e-commerce offer tremendous potential for improving the efficiency of the insurance mechanism and increasing customer awareness and access. However, state-specific regulatory requirements—whether dealing directly with technology or more generally with speed to market for new insurance products—threaten to undermine the ability of insurers, agents, and policyholders to access these technologies fully.

While some aspects of the insurance industry are local in nature, the business is increasingly national, and international, in its customer focus and regulatory needs: The insurance industry is extremely diverse. While a state-based regulatory approach may be appropriate for companies that operate on a single-state or regional basis, for national and international companies—as well as their customers—the current fifty-state regulatory system is costly and inflexible. Moreover, the property/casualty insurance industry is not unique in its sensitivity to local conditions, and in many respects, is increasingly national and international in its orientation. Reforms such as optional federal chartering would allow companies, and customers, to choose the regulatory approach that is most suitable for their size and scope of operations.

Like the industry itself, the challenges facing the property/casualty insurance industry are increasingly national and international in scope: Terrorism, natural catastrophes, fraud, and asbestos litigation are just some of the major issues facing the property/casualty insurance industry. These issues are complex in scope and far-reaching in their financial implications. Because it is decentralized, the current regulatory system lacks the tools to address these issues in a comprehensive manner. Yet, because of the long history of state regulation, Congress is seen as being reluctant to play an affirmative role in addressing these critical issues.

Principles for Optional Federal Chartering

Working with other sectors of the financial services industry through the Financial Services Coordinating Council ("FSCC"), AIA has developed a set of principles for an optional federal charter that that would accommodate all lines of insurance. These principles are as follows:

- *Federal insurers and producers and their customers would enjoy the same high level of protection as state chartered insurers and their customers.*

- *Federal insurers and producers, not taxpayers, would be responsible for the ongoing costs of federal supervision and regulation.*

- *The establishment of a federal insurance regulatory authority within the Treasury Department that would be headed by a person appointed by the president and confirmed by the Senate for a fixed term.*

- *This regulatory authority would regulate exclusively federally chartered insurers and producers. State chartered insurers and producers would continue to be regulated by state regulators.*

Taken together, these principles will assure that the new regulatory system is responsive to the needs of customers and claimants, taxpayers, and the public at large. Moreover, they would avoid "competition in laxity," taxpayer subsidies of the insurance industry, politicization of the regulatory process, dual regulation, and other concerns that have been raised by some of the opponents of optional federal chartering.

Through the FSCC, our organizations also are working to develop a single legislative proposal, which we hope to release shortly. We recognize that this will be a long legislative process, but we look forward to working with you to advance a bill that would result in a safe, sound, and solid new regulatory system.

Consumer and Public Benefits

Optional federal chartering will bring numerous benefits to consumers and the public at large. For example:

- Consumers should realize savings in insurance costs as the market becomes more efficient, competitive, and the costs of unnecessary regulation are squeezed out of the system.
- Consumers are likely to have more product options, particularly with respect to innovative personal and commercial lines coverages.
- Insurance markets will be able to keep up with fast-paced change in the national and international economies in which their customers operate; at the same time, they will be in a position to satisfy the financial needs of locally based businesses, as well as individuals and families.
- The McCarran-Ferguson antitrust exemption would be removed for insurers which no longer are regulated by the states.
- Optional federal chartering also will enhance the U.S. position as a trading partner and address criticisms from abroad that the current system is protectionist.
- Finally, under optional federal chartering, Congress and the regulators will be well equipped to deal with unexpected national or international crises, such as the September 11 terrorism attack, as well as problems (such as long-tail liabilities) that take some time to develop but nonetheless have

huge financial consequences for the insurance industry and the economy at large. Coordination between federal and state regulators, which has begun since enactment of Gramm-Leach-Bliley, would be greatly enhanced.

Conclusion

The combination of financial services, modernization, globalization, technology, and the new risk management challenges facing the insurance industry make comprehensive insurance regulatory reform imperative. The regulatory overhaul must include state-based reforms as well as optional federal chartering. This structure will assure a healthy, consumer-oriented U.S. property-casualty insurance for the 21^{st} century.

We appreciate the Subcommittee's attention to this important issue, and I would be happy to answer any questions you may have. Thank you.

Testimony of

DONALD A. YOUNG, MD

President

HEALTH INSURANCE ASSOCIATION OF AMERICA

On

Insurance Regulation and Competition for the 21st Century

Before The

HOUSE COMMITTEE ON FINANCIAL SERVICES

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND GOVERNMENT SPONSORED ENTERPRISES

Tuesday, June 11, 2002

Introduction

Mr. Chairman, distinguished members of the Subcommittee, I am Donald A. Young, MD, President of the Health Insurance Association of America (HIAA). HIAA is the nation's most prominent trade association representing the private health care system. Its nearly 300 members provide the full array of health insurance products, including medical expense, long-term care, dental, disability, and supplemental coverage to more than 100 million Americans.

HIAA has represented the private health insurance industry since 1956. During that time, we have consistently supported the state regulation of insurance. There are, however, issues that need to be addressed. Among them is "speed to market" – the need to make it easier to bring health insurance products to consumers; avoiding the adverse consequences so often associated with even the best-intentioned efforts to regulate the market; and rationalizing the relationship between state regulations and the growing number of federal requirements being placed on health insurers. In particular, inconsistency between state and federal rules governing the same area is a rapidly growing problem. One suggested solution for these problems, which has been receiving increased attention by the insurance industry, policymakers and others, is the possibility of allowing insurers to choose to be regulated at the federal level rather than the state level.

Current Proposals

Several concrete proposals have been made that would grant insurers the option of seeking a federal charter rather than a state license. Federally chartered insurers would then be allowed to do business in all 50 states without seeking state-by-state licensure, and would primarily be regulated at the federal level. HIAA has not taken a position on any of these proposals. We would, however, make a few observations.

First, current proposals only address a few of the areas in which states regulate health insurance. They are largely focused on licensure, oversight, corporate governance, and financial issues such as solvency and guarantee funds. Typically, they include very little product specific language – to the extent specific insurance products are addressed, most of the authority is delegated to federal regulators through the rule-making process.

Second, the current proposals are structured around the regulation of specific product lines, with federally chartered insurers being licensed to sell one or more products. The breadth of these product lines, and the definitions established for them, would be critical. For instance, would a "health" insurance license include authorization to sell both Medicare Supplement coverage and PPO coverage? Would it include authorization to sell dental coverage? As we have found with the Health Insurance Portability and Accountability Act of 1996 (HIPAA), definitions are critically important. Regulatory requirements intended for comprehensive medical expense insurance are problematic when applied to other forms of coverage, but requiring individual licenses for each product an insurer markets could rapidly become a significant burden without providing any additional protection to consumers.

Third, as currently drafted, optional federal charter proposals would essentially defer most health insurance issues to regulation. This suggests to us that the proponents of these proposals were simply not yet prepared to recommend a proper statutory framework for regulating health insurers at the federal level. The sweeping nature of the authority granted raises the concern that significant public policy issues could be decided by federal regulators, without adequate congressional guidance.

Health Has Unique Issues

While health insurance is a financial instrument, like any other form of insurance, the regulation of health insurance is unique. Most forms of life and property and casualty insurance tend to have relatively few claims; many forms of health insurance, such as medical expense and dental insurance, tend to have very high claim volumes. Most life and annuity claims are for fixed amounts; health insurance claims tend to be much more complex due to the intimate relationship of health insurance coverage to health care delivery and public health policy. Many everyday health insurance functions have no counterparts for most forms of life or property and casualty insurance. Examples are easy to find: utilization review; determining when a treatment is no longer experimental; deciding whether or not clinical trials should be covered; and determining how network providers should be credentialed. (Some forms of property and casualty insurance, such as homeowners, automobile and workers' compensation insurance, do cover some medical losses, and raise some similar issues. However, the focus is on insuring the policyholder's legal liability for an injured individual's medical care. The extent of this liability determines the coverage that is bought; the amount of coverage or type of policy purchased doesn't determine what the policyholder owes the injured party.)

In the public realm, this distinction can be seen between the Social Security and the Medicare programs. Managing the Social Security program can present some very real challenges – but the fundamental issues are all financial; who will receive how much money, and where it will come from. In contrast, the Medicare program has, in addition to questions of eligibility and funding, all of the complexity associated with the management of a health plan. While serving beneficiaries, the Medicare program also has many complex rules and regulations that apply to determining which services will be covered, what's medically necessary, and what payment rates apply. Ensuring that quality health coverage is provided to enrollees inevitably involves questions of ensuring access to affordable health care, combating health care fraud, and ensuring appropriate utilization of medical care, and requires that policymakers make difficult trade-offs between spending on different kinds of services.

It is not surprising that proposals focusing on the financial aspects of insurance would not fully address health insurance issues. However, to be viable for health insurance, any regulatory structure will ultimately have to deal with these questions. In many cases, this may have to be done by statute, rather than by regulation.

Dual Regulation

Perhaps the primary reason an insurer would be interested in a federal charter would be to obtain regulatory "one-stop shopping" – which, for an insurer operating nationwide, could potentially be a significant advantage over dealing with over fifty separate local jurisdictions. An increasingly significant issue, however, is the interaction between state and federal laws and regulations. Health insurance may already be subject to more federal regulation than any other form of private insurance, except perhaps for investment-based life and annuity products that are subject to federal securities regulations as well as state insurance laws. Proposals currently before Congress, such as the "Patients' Bill of Rights," would dramatically expand the federal role.

On the one hand, state regulation has some clear strengths. On the other hand, some health insurers see significant potential advantages in federal regulation if it can simplify the process of operating in multiple jurisdictions. What is incontrovertible, however, is that laying an additional, inconsistent set of federal rules on top of the existing state rules is the worst of both worlds. Privacy is a good example of this.

The Congress has now twice adopted laws relating to the privacy of health information, the Gramm-Leach-Bliley Act (GLBA) and the Health Insurance Portability and Accountability Act (HIPAA). The former is being implemented through state laws, not all of which are uniform. The latter is being implemented through federal regulations that are still in some flux. In addition, HIPAA does not fully preempt state privacy laws, but instead allows state laws more restrictive than federal requirements to continue to apply. This forces insurers and other covered entities to determine whether state laws are or are not more protective than the federal requirements, not always an easy thing to determine, and then to implement a compliance plan, which by definition will involve greater complexity than would be true if only a single uniform privacy law applied.

This state of affairs caused HIAA, in conjunction with other collaborating associations, to engage outside legal experts to conduct a state-by-state assessment of privacy laws and provide advice about which of them would still apply under the kind of federal preemption provided by HIPAA. This initiative was extremely expensive. And since states continue to pass privacy legislation and/or adopt privacy regulations, this will not be a one-time endeavor, but must be regularly updated. The lack of uniformity in the area of privacy regulation explains why HIAA continues to believe that federal preemption of all state privacy laws is essential if we are to minimize the administrative burden on insurers and other covered entities. It goes without saying, of course, that increased administrative burden translates into higher insurance premiums, and these premiums are already being pressured by the ever-rising costs of health care services.

The problem of dual regulation extends beyond the question of whether or not an optional federal charter should be available. Whenever Congress decides to step into an area already regulated by the states, it is critical that it do so in a way that does not add to an already significant regulatory burden. With privacy, there was an opportunity to make the regulation of health insurance simpler and more consistent – that opportunity was missed. In that case, preempting the patchwork quilt of inconsistent state regulations with a single federal standard would have been far superior. Other alternatives may be appropriate in different situations. For example, HIPAA set federal standards for group-to-individual "portability," but allowed each state to determine the most appropriate local mechanism for meeting those standards, successfully avoiding the problems of dual regulation.

Market Fragmentation

One challenge that state policymakers continually struggle with is the need to avoid fragmenting the various health insurance markets. Or, from the point of view of insurers, the need to maintain a level playing field between different market participants. When different organizations offering coverage to the same set of consumers, such as small employers, are subject to different market rules opportunities are created to divide insurance pools, undermining the effectiveness of the insurance mechanism.

Perhaps the best example of this is the division between state-regulated insured health plans and federally regulated self-insured programs that was created by the Employee Retirement Income Security Act of 1974 (ERISA). Among other things, ERISA was intended to make it easier for employers, especially those with employees in multiple states, to manage their employee benefit programs. ERISA deferred to the state in the regulation of the business of insurance, but preempted all other state efforts to regulate employee benefit plans.

Thus, the health plans of those employers, generally small, who provide benefits through an insurance contract are subject to state insurance law. On the other hand, the health plans of those employers who self-insure their benefit plans are exempt from state insurance law.

ERISA has been of significant benefit to large employers, allowing them to provide health benefits to their employees more efficiently and at lower cost, and protecting them from the unanticipated adverse consequences of many state regulatory initiatives. It has also created some public policy challenges. Much of the impetus for federal intrusion into the regulation of health insurance has come from the realization that roughly half of all employees with employer-sponsored health benefits are in plans that are exempt from state regulation.[1] While most of the federal initiatives deal with issues that states are already actively addressing for insured programs, such as the regulation of managed care and minimum requirements for mental health coverage, they invariably include insured plans as well as self-insured ones – thus expanding the problem of dual regulation.

The division created by ERISA between state-regulated insured health plans and federally regulated self-insured plans has created some market fragmentation. Perhaps the best example is the small group market. Most states have enacted comprehensive small group reform laws. Small employers willing to self-insure have been able to use ERISA pre-emption to opt-out of these reforms, however, limiting states' ability to restructure the market. While on the one hand it has allowed some employers to escape state requirements that unnecessarily increase the cost of coverage, on the other hand it has distorted the market by applying significantly different rules to different market participants. (It has also reduced the assessment base available to states for such health-related initiatives as high-risk pools.) A fundamental difference between banking and

[1] *Employer Health Benefits: 2002*, The Henry J. Kaiser Family Foundation and Health Research and Educational Trust, September 2001, p. 130.

insurance is that insurance is based on the pooling of risks. Whenever the development of an alternative insurance regulatory mechanism is considered, a key challenge is ensuring that markets are not divided in a way that undermines their ability to effectively pool risks.

Particularly damaging have been the fraudulent health plans that have periodically sprung up, outside the state regulatory structure, often claiming some sort of federal authority. Insurance regulators all over the country are deluged with complaints, long after the fact, about unpaid claims – by which time the operators have long since moved on. Prime examples have been self-insured Multiple Employer Welfare Arrangements (MEWAs) or Multiple Employer Trusts (METs) that offer very small employers self-insured "coverage." Since these programs were self-insured, they claimed exemption from state insurance law by ERISA; but since ERISA was never intended to regulate organizations operating as quasi-insurers, it provided inadequate protections against insolvency and fraud. Fundamentally, these abuses have been the result of individuals attempting to exploit perceived cracks and ambiguities in the regulation of health plans. These are some of the fundamental considerations behind our opposition to proposals that would authorize the establishment of HealthMarts or Association Health Plans (along with research showing that purchasing alliances are not in fact effective in reducing the cost of coverage[2]).

What it Would Take

Establishing an optional federal insurance charter that encompassed the full range of insurance products would require a very careful review of existing state regulatory and other oversight roles and responsibilities, decisions about which of these need to be replicated in a federal regulatory structure, and then a determination, in each instance, of the specific regulatory policy that will apply to federally regulated insurers. In this

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[2] U.S. General Accounting Office, *Private Health Insurance: Cooperatives Offer Small Employers Plan Choices and Market Prices*, March 2000, GAO/HEHS-00-49;
Elliot K. Wicks, Mark A. Hall and Jack A. Meyer, *Barriers to Small-Group Purchasing Cooperatives, Economic and Social Research Institute*, March 2000;
Stephen H. Long and M. Susan Marquis, "Pooled Purchasing: Who Are the Players?" *Health Affairs*, July/August 1999, p. 105-111.

regard, it needs to be understood that there is now a fair amount of variability in state insurance regulations, and a federal regulatory structure would presumably involve either picking and choosing from among the current range of state requirements to find the most appropriate one for application to federally regulated insurers, or creating some new federal policy not currently found in any state. This is a significant challenge. A simple review of the model acts and regulations that have been promulgated by the National Association of Insurance Commissioners (NAIC) would quickly illustrate the magnitude of this challenge. Moreover, a federal charter option would also require building an entirely new federal bureaucracy performing functions and handling issues that have never before been addressed at the federal level.

State insurance regulators play a number of key roles, including protecting the solvency of insurers (and thus ensuring that they are able to keep the promises they make to policyholders), protecting the interests of consumers, and limiting the effects of financial failing in the industry. This means that they must:

- Regulate Insurers' Financial Statements;
- Regulate Insurers' Investments (Permissible and Non-Permissible);
- Perform Financial Examinations;
- Oversee Mergers and Acquisitions (very specific rules);
- Review and Approve Premium Rates and Policy Forms;
- Regulate Form and Substance of Disclosures;
- Regulate Discontinuance and Replacement of Policies;
- Investigate Consumer Complaints and Respond to Inquiries;
- Perform Market Conduct Examinations;
- Investigate and Prosecute Insurance Fraud;
- License and Regulate Insurance Agents;
- Regulate Trade and Claim Payment Practices; and
- Supervise Receiverships, Insolvencies and Liquidations (the focus is on the protection of policyholders – not creditors).

State insurance law is generally well established, having been developed over a period of decades. Most statutory changes represent fine-tuning of existing regulatory structures, rather than the wholesale development of new law. As a result, such changes as are made are generally implemented fairly quickly, and states typically have an excellent track record of promptly publishing rules interpreting new statutes.

Unanticipated Consequences

As this committee considers the future of insurance regulation, HIAA believes it is important to understand that health insurance regulatory initiatives can have adverse consequences unanticipated by their proponents.

Benefit mandates provide an excellent example. Mandates are often seen as a way for legislators to provide a social good, such as cancer screening or smoking cessation programs, with little or no impact on government spending. But however well intentioned, mandates ultimately harm consumers by raising the cost of health insurance, placing it beyond the financial reach of even more individuals and small employers. The primary reason almost 40 million Americans are uninsured[3] is the high cost of health care and health care coverage.[4]

I'm happy to report that an ever-increasing number of states are recognizing this problem, and taking steps to address it. For example, some states are creating special commissions to examine the impact of benefit and other state mandates and to provide advice to legislators about future legislation in this area. On the other hand, I also need to acknowledge that mandates are not uniquely a state invention. Unfortunately, a number of bills currently before this Congress, including those relating to colon cancer screening, mental health parity, and patients' bill of rights, would impose a dizzying array of additional mandates on health insurers, thereby driving up the cost of coverage.

[3] Mills, Robert J., *Health Insurance Coverage: 2000*, U.S. Census Bureau, September 2001.
[4] Custer, William S. and Ketsche, Patricia, *The Changing Sources of Health Insurance*, HIAA, December 2000

Individual health insurance market guaranteed issue and community-rating requirements are another good example of how well intentioned reform efforts can have serious adverse consequences. Guaranteed issue and community rating requirements attempt to subsidize high-risk individuals by asking low-risk individuals to pay more. However, coverage is then no longer equally financially attractive for all consumers. From the standpoint of the low-risk individual, the additional cost does not bring additional value. As a consequence, many individuals will simply choose to forgo coverage.

State experience with guaranteed issue and community-rating requirements confirms this – they tend to increase average premiums and decrease, rather than increase, the number of individuals covered by health insurance.[5] Kentucky and Washington State provide good examples. Overly restrictive individual health insurance market reform efforts destroyed the ability of insurers to offer affordable coverage to individuals in those states, forcing them to exit the market. As a result, many consumers were left with few if any coverage alternatives.

I should note that other states have found ways to ensure access to affordable coverage without resorting to guaranteed issue and community rating requirements that undermine the market. State high-risk pools have proven effective mechanisms to guarantee access, because they incorporate a significant subsidy from outside the pool. The purpose of these pools is not to "share" costs between pool enrollees, which would be ineffective, but rather to transfer some of the cost of covering these high-cost individuals to a broader revenue base.

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[5] L. Nichols, "State Regulation: What Have We Learned So Far?" *Journal of Health Politics, Policy and Law* (February 2000): 175-196;
W. Custer, *Health Insurance Coverage and the Uninsured* (Washington, D.C.: HIAA, December 1999), 13-14;
F. Sloan and C. Conover, "Effects of State Reforms on Health Insurance Coverage of Adults," *Inquiry* (Fall 1998): 280-293;
M. Schriver and G. Arnett, *Uninsured Rates Rise Dramatically in States with Strictest Health Insurance Regulations* (Washington, D.C.: The Heritage Foundation, August 20, 1998), 1-2;
J. Marsteller et al., *Variations in the Uninsured: State and County Level Analyses* (Washington, D.C.: The Urban Institute, June 11, 1998), ii;
For a perspective from the front lines, see the report developed by the staff of the Maine Bureau of Insurance – *White Paper: Maine's Individual Health Insurance Market* (Augusta, Maine: Maine Bureau of Insurance, January 11, 2000), 7-8.

Any significant restructuring of the way in which health insurance is regulated must be done very carefully to avoid adverse effects. In a broader context, HIAA strongly recommends that costs associated with benefit mandates be carefully weighed, and that guaranteed issue or community rating requirements not be placed on the individual health insurance market. Rather, access to coverage should be guaranteed to individuals with serious health conditions through broadly funded high-risk pools.

Finally, in speaking of unintended consequences, one key difference between federal and state policy making should be kept in mind. If an individual state adopts a mandate or regulation that ends up having serious negative consequences for the health insurance sector, the damage is obviously more narrowly contained than would be the case if the same policy had been adopted at the federal level.

Other Initiatives

It is also important to note that the states, through the NAIC, are making serious efforts to streamline the insurance regulatory process. The NAIC has long played an important role in encouraging consistency among the states, and improving speed-to-market is currently a priority at the NAIC. We are aware that the NAIC is also now exploring the possible use of interstate compacts as a way to improve consistency and reduce the regulatory burden. Such compacts raise a host of structural, process and policy issues, and we anticipate working very closely with state insurance regulators and other interested parties to help assess these matters.

Conclusion

In conclusion, I must emphasize that HIAA has taken no position on the optional federal charter issue. While we have long supported the state regulation of health insurance, we remain concerned about a number of aspects of the current regulatory environment. For example, there is a very real need to streamline the regulation of health insurance and make it more consistent across jurisdictions. To ensure a competitive market, we must make it quicker and easier for insurers to bring new products to consumers – this is particularly important for health insurance, as we strive to bring affordable coverage within the financial reach of more Americans. Inconsistent and overlapping federal and state requirements are a growing problem that must be addressed. Above all, whether in a state or federal context, we urge policy makers to carefully consider the cost consequences of their actions, since even the most well-intentioned regulations or mandates can end up making it more difficult to provide and obtain affordable health insurance coverage.

Mr. Chairman, I hope that my testimony today helps elucidate some of the many unique issues associated with the regulation of health insurance. HIAA would welcome the opportunity to work further with you and your committee as you continue to examine these issues.

United States House of Representatives
Committee on Financial Services

"TRUTH IN TESTIMONY" DISCLOSURE FORM

Clause 2(g) of rule XI of the Rules of the House of Representatives and the Rules of the Committee on Financial Services require the disclosure of the following information. A copy of this form should be attached to your written testimony.

1. Name:	**2. Organization or organizations you are representing:**
Donald Young, M.D.	Health Insurance Association of America, (HIAA)
3. Business Address and telephone number: 1201 F Street, NW Suite 500 Washington, DC 20004-1204	
4. Have you received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2000 related to the subject on which you have been invited to testify?	**5. Have any of the organizations you are representing received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2000 related to the subject on which you have been invited to testify?**
☐ Yes ☑ No	☐ Yes ☑ No
6. If you answered "yes" to either item 4 or 5, please list the source and amount of each grant or contract, and indicate whether the recipient of such grant was you or the organization(s) you are representing. You may list additional grants or contracts on additional sheets.	
7. Signature: Donald Young	

Please attach a copy of this form to your written testimony.

A P P E N D I X

June 18, 2002

Opening Statement

Chairman Michael G. Oxley

Committee on Financial Services

Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises
"Insurance Regulation and Competition for the 21st Century"

June 18, 2002

Today, the Committee holds its third and final hearing in its series examining various proposals to reform insurance regulation. I am very pleased that Chairman Baker has devoted so much time and energy to this issue, which is of the utmost importance to insurance consumers across the country. While we have just scratched the surface of this very complicated matter, this series of hearings has established the foundation for the Committee's future work in this area. And I can assure you, there will be future work. This Committee will remain focused on this issue until true reform is achieved.

As many of you know, my interest in reform is not new. Several years ago I asked the National Association of Insurance Commissioners to focus on this glaring problem, and they responded in March, 2000 with a *Statement of Intent: The Future of Insurance Regulation* which established the NAIC's platform for modernizing insurance regulation. It was a good first step and laid out goals and timetables for action.

Since that time, the NAIC has experienced some success and some failures. In the face of Congressional legislative pressure, the NAIC has made significant progress in agent licensing reform, and I commend their efforts. However, there is still much work to be done: first to make reciprocity a reality in every State and to achieve the ultimate goal of uniformity. I also remain troubled that many of the larger States with the bulk of the agent/broker population have either not yet passed legislation or have passed legislation that may not meet NARAB requirements.

Unfortunately, the NAIC has met with less success in its efforts to modernize the product approval process. Almost a year ago to the day, the NAIC testified before this Subcommittee and held out CARFRA as the solution to the life insurance product approval problem. Now the NAIC has largely abandoned the initial CARFRA approach, and has shifted gears to an interstate compact mechanism. The interstate compact mechanism has been around for quite some time and raises some difficult issues. It is too early to say whether such a system will succeed or fail, but one thing is for certain, consumers cannot afford another misstep.

Oxley, page two
June 18, 2002

I am not here to blame the NAIC for a lack of reform. The leadership team at the NAIC has done yeoman's work, and I would like to thank Commissioner Terri Vaughan, who is with us today, Ohio Commissioner Lee Covington, Illinois Commissioner Nat Shapo, and others, for their important leadership efforts. To a large degree, their hands are tied. The NAIC can approve initiative after initiative, but it is the State legislatures that must act on them. Unfortunately, it is becoming increasingly apparent that the NAIC may be facing an insurmountable task.

It is my sincere hope that the alliance between the NAIC and State legislators brings reform to the industry. However, this Committee will not sit idly by. I am committed to continuing working on this issue for the long haul, looking at all the different facets of the industry. We will keep building on our reform efforts, and we will not let up until consumers receive the most effective and competitive marketplace that can be created.

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**OPENING STATEMENT OF
RANKING DEMOCRATIC MEMBER PAUL E. KANJORSKI**

**SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE,
AND GOVERNMENT SPONSORED ENTERPRISES**

**THIRD HEARING ON INSURANCE REGULATION AND
COMPETITION FOR THE TWENTY-FIRST CENTURY**

TUESDAY, JUNE 18, 2002

Mr. Chairman, we meet today for a third time to analyze various proposals to increase the efficiency and uniformity of insurance regulation in the United States. I again commend you for your diligence in convening this series of hearings. Today's proceedings should help us to better appreciate the regulatory models used in other sectors of the financial services industry and how these sectors might be affected under various proposals to reform insurance regulation.

At our previous hearings, we have heard from both sides of the ongoing policy debate about reforming insurance regulation and creating an optional federal charter. Some of our witnesses have argued that the needed reforms are most appropriately pursued at the state level. Others have suggested that joint state and federal oversight would most effectively address the regulatory efficiency problems plaguing the industry. We will hear similar views today.

No matter what side one takes in this long-standing debate, it has become clear to me that this is no longer a question of whether we should reform insurance regulation in the United States. Instead, it has become a question of how we should reform insurance regulation. This reform effort will likely prove difficult given the diversity and complexity of the insurance industry. As a result, I suspect that it will take us at least several years to forge a consensus on this complicated set of issues.

Later today, I plan to continue to explore whether we should create a tiered regulatory structure for insurance, similar to the oversight system we devised for investment advisors. Under this system, the federal government would regulate insurers above a certain size or in certain business lines, while states would retain the responsibilities for regulating the rest.

We should also continue to carefully examine consumer issues as we proceed in the weeks ahead. We should, for example, find out the costs and benefits of a streamlined regulatory system. We should further determine what safeguards are needed to protect the interests of consumers. In the end, consumers should be the ultimate beneficiaries of our actions.

Additionally, Mr. Chairman, I am particularly pleased that Wayne McOwen will testify before us today. Mr. McOwen serves as a Senior Vice President for Guard Financial Group, which is based in my congressional district. Guard Financial Group operates several subsidiaries and affiliates that participate in various aspects of the insurance and financial services industries. I have previously found Mr. McOwen's insights informative and instructive, and his comments today will help us all to better understand the needs of a small, progressive insurer.

In closing, I look forward to hearing from our distinguished witnesses and to learning more about their views for improving insurance industry regulation. As we continue to examine these issues, I am confident that our careful analysis will allow us to eventually identify a bipartisan consensus on the most effective and appropriate way to move forward.

Opening Statement
Congressman Ed Royce (CA-39)
18 June 2002
Insurance Regulation and Competition for the 21st Century

Thank you, Mr. Chairman, for the opportunity to address the issues pertaining to insurance regulation and competition raised by these two panels of witnesses here today. I would like to commend the chairman for his unwavering commitment to approaching the topic of possibly creating an optional federal charter for insurance companies in such a deliberate, comprehensive and thorough manner. I also greatly look forward to hearing what today's witnesses have to contribute to the ongoing discussion initiated by this subcommittee on this issue.

As I have mentioned in my statements during the two previous subcommittee hearings on this matter, I am interested in hearing our witnesses' thoughts on what steps Congress could take to improve the current system while allowing the principles of the free market to work. I would be particularly interested to hear our witnesses identify the federal legislative tools that they think Congress could best employ to meet the goal of increased efficiency in the insurance industry, particularly in the area of bringing insurance products more speedily to market.

As some of the other members of this committee, including Chairman Oxley, have mentioned in their statements, the National Association of Insurance Commissioners (NAIC) has done an admirable job of bringing some much-needed reforms to the insurance industry, particularly in the area of agent licensing. But much work still needs to be done in that area to make reciprocity a reality in every state and to achieve the ultimate goal of uniformity across all states. Likewise, much work must still be done in the areas of increasing speed-to-market for product approval and improving fairness in international competition for American insurance and reinsurance companies.

I believe that Congressional action, in the form of either targeted legislative action or the creation of an optional federal charter, may be warranted to address some of these concerns and to fix some of the ongoing problems in the insurance industry. It is my hope that today's hearing and future committee work on this matter will help to determine what the appropriate Congressional response should be to address fully this complicated issue.

I would like to once again commend the chairman for his leadership on these issues, and I look forward to hearing from our witnesses today to see what Congress can do to address these and other issues associated with insurance regulation and competition in the 21st Century. I yield back the balance of my time.

Opening Statement for the Record
Congresswoman Nydia M. Velázquez
Housing and Community Opportunity Subcommittee Mark-Up
of H.R. 3995, The Housing Affordability for America Act
June 18, 2002

I would like to thank Chairwoman Roukema and Ranking Member Frank for bringing this bill up for consideration by the Subcommittee today. The Housing Affordability for America Act contains a large number of provisions which will help our lowest income families find housing and to springboard lower-middle income families to the dream of homeownership.

I would like to particularly thank the Chairwoman for her willingness to work with me to address to issues of particular concern to me. First, the managers amendment includes an amendment I noticed which will require that all first time homebuyers, purchasing in a neighborhood with high foreclosure rates, be provided with homebuyer counseling by a HUD-approved not-for-profit.

Homeownership is a vital part of the American dream, but it too often becomes a nightmare when first time homebuyers are not made aware of all of the terms of the mortgage and find out -- often too late -- that they can not meet the monthly payments.

Low income neighborhoods in New York, and across the nation have met with a similar problem: twenty years ago we couldn't get lenders to invest. Today, the investment exists, but it is frequently in the form of loans that have unfair and unrealistic terms. More alarming still is the growing pattern of foreclosures on FHA-insured properties in low-income and minority neighborhoods. Many of these foreclosures could have been avoided had the buyer been aware of the unrealistic terms of the loan.

By providing homebuyer counseling in areas predisposed to such loans we can limit the number of foreclosures, and prevent neighborhoods from being caught in the cyclical, large-scale abandonment of properties which causes blight. I appreciate the inclusion of the provision in the manager's amendment.

The second amendment which I offered and was accepted to the manager's amendment reforms Section 3 of the 1968 HUD Act. This provision requires that all recipients of HUD funds, and their contractors and subcontractors, make best possible efforts to provide jobs and other economic opportunities to low-income people. In most localities, this has never occurred.

It has become evident that a major problem with this requirement is a lack of enforceable language. How are the PHAs and the tenants, who know that very little, if any, effort is being made to recruit public housing residents for these jobs supposed to prove it. And even if they could prove it, they have no recourse.

My amendment would eliminate debate concerning what "all best possible efforts" truly entails by replacing this language with contracting goals. Specifically, it would require that on all contracts worth more than $500,000, 30% of labor costs be used to hire eligible Section 3 applicants. It further states that all such contracts must include a plan for meeting Section 3 hiring goals.

Section 3 is a program with great possibilities. It has the potential to provide more than just stop-gap employment for our lowest-income citizens. Ideally, it will provide these individuals with access to careers with decent salaries and benefits. But, it clearly will not happen until we send a message to all of those companies contracting with our PHAs that we are serious about the enforcement of our economic self sufficiency programs.

The Housing Affordability for America Act will improve access to safe, decent, affordable housing for people across the country. I applaud the Chairwoman for her willingness to work with all of the Members of the Committee to produce a bill which can be supported by such a wide spectrum of Members and I encourage my colleagues to support passage.

Independent Insurance Agents
& Brokers of America, Inc.

THOMAS B. AHART
AHART, FRINZI & SMITH
On Behalf of the

INDEPENDENT INSURANCE AGENTS & BROKERS OF AMERICA

BEFORE THE HOUSE SUBCOMMITTEE
ON CAPITAL MARKETS,
INSURANCE AND GOVERNMENT
SPONSORED ENTERPRISES

JUNE 18, 2002

Independent Insurance Agents & Brokers of America, Inc.

STATEMENT OF THE INDEPENDENT INSURANCE AGENTS & BROKERS OF AMERICA

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES

FINANCIAL SERVICES COMMITTEE

UNITED STATES HOUSE OF REPRESENTATIVES

June 18, 2002

Good afternoon Chairman Baker, Ranking Member Kanjorski, and Members of the Subcommittee. My name is Tom Ahart, and I am pleased to have the opportunity to give you the views of the Independent Insurance Agents & Brokers of America (IIABA) on the current state of insurance regulation and IIABA's views on the role Congress can play to eliminate the flaws in the current system. I am President of the Ahart, Frinzi & Smith Insurance Agency in Phillipsburg, New Jersey. I also currently serve as President of the IIABA.

IIABA is the nation's oldest and largest national trade association of independent insurance agents and brokers, and we represent a network of more than 300,000 agents, brokers and agency employees nationwide. IIABA members are small, medium and large businesses that offer customers a choice of policies from a variety of insurance companies. Independent agents and brokers offer all lines of insurance—property, casualty, life, health, employee benefit plans and retirement products.

Introduction

At the outset, Chairman Baker, I must note that IIABA applauds the subcommittee and full committee's continuing efforts to analyze and assess the challenges that face the state-based system of insurance regulation. Last summer, we were afforded the opportunity to testify at a hearing you held examining the manner in which states currently oversee and approve insurance products, and that hearing brought to light many of the inefficiencies, idiosyncrasies, flaws, delays and redundancies associated with the existing system of oversight and review. It is our expectation that this hearing is another step in what promises to be a comprehensive and ongoing process, and we hope we will have the opportunity to present our views at each and every stage of your deliberations on these crucial questions.

In the year that has passed since that last hearing, the perceived need for reform has increased. The enactment of financial services modernization legislation and the emergence of an increasingly more consolidated, more global financial services industry have sparked new interest in the concept of an "optional" federal insurance charter and, more generally, in federal regulation of the business of insurance. Proponents of such proposals argue that federal insurance regulation would promote greater uniformity, reduce costs and cause less frustration than the current multi-state system.

IIABA believes it is essential that all financial institutions be subject to efficient regulatory oversight and that they be able to bring new and more innovative products and services to market quickly to respond to rapidly evolving consumer demands. Over the last two weeks, this subcommittee has heard testimony concerning the deficiencies and inefficiencies that exist today, and there is no doubt that the current state-based regulatory system must be reformed and modernized. At the same time, however, the current system is exceedingly proficient at insuring that insurance consumers—both individuals and businesses—receive the insurance coverage they need and that any claims they may experience are paid. These aspects of the state system are working well, and this Committee has heard no testimony to the contrary. The optional federal chartering proposals, however, would displace these well-running components of state regulation as well and, in essence, thereby "throw the baby out with the bathwater."

As we have for over 100 years, IIABA strongly supports state regulation of insurance—for all participants and for all activities in the marketplace. Yet despite this historic and longstanding support, we are not confident that the state system will be able to resolve its problems on its own. In fact, we feel there is a vital and immediate role for Congress to play in helping to reform the state regulatory system, and such an effort need not replace or duplicate what is already in place at the federal level. We propose that two overarching principles should guide any such efforts in this regard. First, Congress should attempt to fix only those components of the state system that are broken. Second, no actions should be taken that in any way jeopardize the protection of the insurance consumer, which is, at bottom, the fundamental objective of insurance regulation.

Under the proposal that IIABA has been developing in conjunction with a broad-based group of insurers and insurance producers, these overarching principles would be satisfied through an approach under which—

(1) Every insurer, agent and broker would be subject to only a single—albeit a state—regulator for licensing determinations, solvency regulation, financial audits, corporate transaction reviews and corporate governance requirements;

(2) The procedures under which states review proposed insurance policy forms would be limited to 30 days, and the requirements that apply to rate approvals essentially would be eliminated for any insurance coverage sold in a "competitive" marketplace; and

(3) Although no substantive consumer protection requirements would be eliminated or displaced, incentives for states to create compacts to streamline the market conduct examination process would be provided and limitations would be placed on the ability of state regulators to conduct "fishing expedition"-type examinations.

To explain the rationale under girding this approach, I will first offer an overview of both the positive and the negative elements of the current insurance regulatory system. I will then provide a more complete explanation of IIABA's proposal to address the negative while retaining the positive elements of the current system.

I. The Current State of Insurance Regulation

As the United States Supreme Court has so aptly put it, "[p]erhaps no modern commercial enterprise directly affects so many persons in all walks of life as does the insurance business. Insurance touches the home, the family, and the occupation or the business of almost every person in the United States."[1] "It is practically a necessity to business activity and enterprise."[2] Insurance serves a broad public interest far beyond its role in business affairs and its protection of a large part of the country's wealth. It is the essential means by which the "disaster to an individual is shared by many, the disaster to a community shared by other communities; great catastrophes are thereby lessened, and, it may be, repaired."[3] Thus, it is "the conception of the lawmaking bodies of the country without exception that the business of insurance so far affects the public welfare as to invoke and require governmental regulation."[4] Since the inception of the business of insurance in the United States, it is the states that have carried out that essential regulatory task. Today, state insurance departments employ over 11,000 individuals and address hundreds of thousands of consumer complaints and inquiries annually, and they draw on over a century-and-a-half of regulatory experience they endeavor to protect the insurance consumers of this country.

These core regulatory tasks of state insurance regulators can essentially be divided into the following eight categories:

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1 *United States v. South-Eastern Underwriters Ass'n*, 322 U.S. 533, 540 (1944).
2 *German Alliance Ins. Co. v. Lewis*, 233 U.S. 389, 415 (1914).
3 *Id.* at 413.
4 *Id.* at 412.

(1) Regulation of the coverage parameters of insurance contracts;
(2) Sales practices regulation;
(3) Claims practices regulation;
(4) Claims dispute mediation/resolution;
(5) Claims payment guarantees—state guaranty funds regulation and solvency regulation;
(6) Claims payment guarantees—qualification standards and financial audits;
(7) Insurer licensing, merger review and corporate governance regulation; and
(8) Insurance agent/broker licensing and qualifications to do business regulation.

As a general matter and as explained in more detail below, the regulatory performance of the state system on the first five of the eight categories—all of which directly involve regulation of the interaction between the consumer and the insurer—is superlative. It is only with respect to determining and monitoring insurers, agents, and brokers' qualifications to do business and financial health that the state system has developed the inefficiencies that are now the focal point of the cries for reform.

a. The Positive—Protecting Consumers and Ensuring Claims Are Paid

The goal of all insurance is to protect the purchaser (or their heirs) from calamity. At its most basic level, this means that the consumer purchases an insurance contract and, in exchange for the premium paid for that contract, the consumer receives a promise from the insurance company that they will be compensated for any losses they experience that are covered under that contract. From the consumer perspective, it is imperative that the insurance contract be adequate for their needs and that the insurer actually pay any claims that are made under that contract. In both of these respects, the historical performance of state insurance regulators is impeccable—they ensure that necessary coverage minimums are included in insurance contracts and, perhaps even more importantly, they make sure legitimate claims are paid.

Regulators play two very distinct roles in ensuring that claims are paid. First, they are responsible for guaranteeing that funds are available to pay any and all claims that arise. Despite their best efforts to oversee and audit insurers' financial solvency, insurance companies—like national banks and savings and loans—sometimes fail. The state system of insurer guaranty funds—which are like Federal Deposit Insurance Corporation (FDIC) insurance but for insurance companies instead of banking institutions—works. It has paid out over $11 billion to cover claims asserted against insolvent insurers since they were first created in the mid-1970s, and none of that money has been at taxpayer expense.

Second, state regulators play a vital role in mediating disputes that arise on a daily basis between consumers who have submitted claims and insurers who contend that the claims either are illegitimate or are not covered by the insurance policy. The respective bargaining positions between tens of millions of insureds—such as individuals and small businesses—and their insurers is tremendously skewed. Insurance consumers therefore regularly rely on the intervention of state regulators on their behalf when claims disputes arise. Large segments of every insurance department in the country are dedicated to assisting with the resolution of such disputes, and all available evidence suggests that insurance consumers are very satisfied with those local efforts.

b. The Negative—Product Regulation and Duplicative Oversight

If you review all of the testimony you have received to date, it becomes evident that all of the perceived shortcomings of state regulation of insurance fall into two primary categories—it simply takes too long to get a new insurance product to market, and there is unnecessary duplicative regulatory oversight in the licensing and post-licensure auditing process.

In many ways, the "speed-to-market" issue is the most pressing and the most vexing from both a consumer and an agent/broker perspective because we all want access to new and innovative products that respond to identified needs. The reality of today's marketplace is that banking institutions and securities firms are able to develop and market new and more innovative products and services quickly, while insurance companies are hampered by lengthy and complicated filing and approval requirements in all 50 states. As a result, insurance companies —and, derivatively, agents and brokers selling their products and services—are at a competitive disadvantage compared to their counterparts in other financial services industries.

Today, insurance rates and policy forms are subject to some form of regulatory review in nearly every State, and the manner in which rates and forms are approved and otherwise regulated can differ dramatically from State to State and from one insurance line to the next. While most insurance codes provide that policy rates shall not be inadequate, excessive or unfairly discriminatory, and that policy forms must comply with state laws, promote fairness, and be in the public interest, there are a multitude of ways in which States currently regulate rates and forms. These systems include prior-approval, flex-rating, file-and-use, use–and-file, competitive-rating and self-certification. These requirements are important because they not only affect the products and prices that can be implemented, but also the timing of product and rate changes in today's competitive and dynamic marketplace.

The current system, which may involve seeking approval for a new product or service in up to 55 different jurisdictions, is too often inefficient, paper intensive, time-consuming, arbitrary and inconsistent with the advance of technology and regulatory reforms made in other industries. As you have heard previously, it often takes two years or more to obtain regulatory approval to bring new insurance products to market on a national basis. Cumbersome inefficiencies create opportunity costs, and the regulatory regime in many States is likely responsible for driving many consumers into alternative markets mechanisms. As a result, the costs of insurance regulation are exceeding what is necessary to protect the public, particularly in the area of commercial insurance. In order to keep insurers competitive with other financial services entities and maximize consumer choice in terms of the range of products available to them, changes and improvements are needed.

Similarly, insurers are required to be licensed in every State in which they offer insurance products, and the regulators in those states have an independent right to determine whether an insurer should be licensed, to audit its financial solvency and market-conduct practices, to review mergers and acquisitions, and to dictate how the insurer should be governed. With the exception of market-conduct examinations, it is difficult to discern how the great cost of this duplicative regulatory oversight is justified, especially in light of the fact that the underlying solvency requirements are essentially identical from State to State. Market conduct examinations present a somewhat more thorny issue because, although the majority of sales and claims practices requirements and prohibitions are similar across the country, there are local variations. It is, of course, difficult for a regulator to determine compliance with another jurisdiction's requirements. At the same time, it seems wholly unnecessary for each regulator to examine every insurer on every aspect of their compliance practices given that there is such an extensive overlap in requirements.

2. Solutions

Although heroic efforts have been made to date, state regulators and legislators face the near impossible challenge of addressing and remedying the identified deficiencies unilaterally. For the most part, these reforms must be made by statute, and state lawmakers face practical and political hurdles and collective action challenges in their pursuit of such improvements on a national basis. Despite the actions of the States on producer licensing reform over the last two legislative sessions, real-world realities suggest that it is extraordinarily difficult, if not impossible, to pass identical bills through the 50 state legislatures

Although the proposed optional federal chartering proposals might correct certain deficiencies, the cost is incredibly high. The new regulator would serve to add to the overall regulatory infrastructure—especially for agents and brokers selling on behalf of both state and federally chartered insurers—and undermine sound aspects of the current state regulatory regime. The best characteristics of the current state system from the consumer perspective would be lost if some insurers were able to escape state regulation completely in favor of wholesale federal regulation. Federal models propose to charge a distant and likely highly politicized federal regulator with the implementation and enforcement of a single set of rules that would apply equally across all States and all insurance markets. Such a distant federal regulator may be completely unable to respond to insurance consumer claims concerns and its mere creation could spark fears that this will prove to be the case. Nor can a single regulatory system harmonize the diversity of underlying state reparations laws, varying consumer needs from one region to another, and differing public expectations about the proper role of insurance regulation. The potential responsiveness of a federal regulator to both industry and consumer needs in several critical areas could therefore jeopardize the fundamental purpose of insurance regulation and must be considered questionable at best.

That the States are better positioned than the federal government to accommodate this diversity or to respond to change, however, is not an adequate defense to the charge that insurance regulation has failed to adapt to changes in the industry and the markets it serves. Weaknesses exist in state regulation today. Unnecessary distinctions among the States and inconsistencies within the States thwart competition, reduce predictability and add unnecessary expenses to the cost of doing business. Similarly, outdated rules and practices do not serve the goals of regulation in today's financial services marketplace. Nevertheless and as noted previously, there is much that is good about the current state-based system that would be jettisoned through the creation of a federal regulator, including an enforcement infrastructure upon which consumers throughout the nation heavily rely to protect their interests. Federal charters and the establishment of a full-blown, unprecedented, untested and likely politicized regulatory structure at the federal level are not the answer.

What is needed is a third way—a system that builds on, rather than dismantles, the States' inherent strengths to meet the challenges of a rapidly changing insurance environment. It must include mechanisms to promote the establishment of more uniform and consistent regulations and regulatory procedures, but must be poised to respond faster and more fully to the reality of electronic distribution and to emerging industry trends such as globalization and consolidation. It must modernize areas in which existing requirements or procedures are outdated, while continuing to impose effective regulatory oversight and necessary consumer protections. The result, for all stakeholders, should be a more efficient, modernized and *workable* system of insurance regulation.

For the last year, IIABA has been spearheading a cooperative attempt to develop just such a proposal. We have been working with other trade associations and directly with an array of national and regional insurers in an effort to identify precisely what must be fixed and how that might be done without displacing the components of the current system that work so well and without creating additional layers of government bureaucracy. Through this process, four specific areas for reform and the constraints on the mechanisms for that reform have been identified, and we have begun assembling a draft proposal for accomplishing these reforms. In my remaining testimony, I will outline the four components of this draft proposal.

a. Rate and Form Filing and Review/"Speed to Market" Reform

As previously discussed, the product regulation requirements in most States require insurers to file new rates and forms with the insurance commissioner and obtain formal regulatory approval before introducing them in the marketplace. Accordingly, an insurer that wishes to introduce a new product on a national basis may be forced to seek approval in up to 55 different jurisdictions. The process can be inefficient, paper intensive, time-consuming, arbitrary and inconsistent with the advance of technology and the regulatory reforms made in other industries. These cumbersome inefficiencies create unnecessary costs and delays, reduce industry responsiveness and drive many consumers into alternative market mechanisms. The regulatory regime in many States exceeds, in terms of scope and cost, what is necessary to protect the public.

In evaluating potential solutions to these problems, it is essential to recognize that uniformity is very difficult to achieve for property and casualty lines product regulation. Due to geography and other factors, some States must take into account issues that other States need not address. In addition, States may subject rates and forms to different levels of regulatory scrutiny, and personal lines and commercial lines products might also be treated differently.

Consumer protection concerns also limit the range of potential options to some extent. The concern is that the quicker and easier it is to have a new product or rate approved, the less protection consumers will receive. The solution thus must strike a balance between timely and quality reviews and appropriate consumer protections. In addition, "race to the bottom" and "turf" concerns have to be taken into account. Particularly under a scheme that employs a single point of review, States that use more stringent rate and form processes will be hesitant to accept the introduction of products or policies approved under more lenient guidelines. We believe it is possible, however, to strike an appropriate balance between realizing meaningful speed-to-market reform and protecting consumer interests.

Based on these objectives and considerations, the IIABA proposal is designed to do three things: (1) make the system more market-oriented; (2) make the system faster; and (3) create greater accountability. On the *form approval* side of the equation, this would be accomplished by preempting any state law that requires more than allowing all proposed forms (both commercial and personal lines) to be used no later than 30 days after they have been filed with the insurance commissioner unless the rate or form is disapproved within that time period. Under such a system, an insurer must at most file a proposed form with the insurance department 30 days in advance of the proposed effective date, and the form be used at that time unless affirmatively disapproved by the regulator. If a department affirmatively approves the filing at any time within the 30-day period, the insurer may use the form immediately. Under the proposal, regulators would be entitled to a single 15-day extension of this disapproval period if an approval application is incomplete, and more permissive state filing/approval requirements would not be affected.

Under this approach, the current requirement that filings be done in every state in which the product will be offered would not be disrupted and current state form requirements would not be preempted (except as discussed below). In both the personal and commercial lines context, any disapproval must be articulated in writing and be based substantively on a properly promulgated statute, regulation or final court order. Many regulators have historically disapproved policy forms based on unpublished and unsubstantiated "desk drawer rules," but such actions would be impermissible under our approach. As noted previsously, more permissive form filing and approval requirements would not be displaced by the federal rules.

Under our draft proposal, *rate approval* is treated much differently than form approval because the competitive market generally is the most efficient and effective regulator for rates. At the same time, in markets that are not sufficiently competitive, regulators need to retain the ability to monitor rates and to intervene to disapprove rates when necessary. Accordingly, under the draft proposal, any regulatory review requirement for rates in competitive markets that requires more than the filing of the rates with the insurance department would be preempted. States, however, will remain empowered to approve or disapprove rates in "non-competitive" markets if an affirmative finding has been made determining that the market is "non-competitive." That determination would be subject to federal court scrutiny under the proposal.

b. Producer Licensing

Insurance agents and brokers must be licensed in every State in which they conduct business, and many producers face considerable hurdles in complying with inconsistent, duplicative and unnecessary licensing requirements when they operate on a multi-state basis. Although state licensing reforms adopted over the last two years offer great promise, additional improvements and refinements are necessary. The core proposal that we are developing to address this problem is to mandate licensing reciprocity in all states and thus achieve meaningful licensing reform that is national in scope. This could be accomplished by prohibiting a State in which an agent or broker is seeking to be licensed on a non-resident basis from imposing any licensure requirement on that person other than submission of proof of licensure in their home state and the requisite fee. Under a reciprocal licensing system that is national in scope, any individual agent or broker would only be confronted by a single set of licensing requirements.

The largest potential impediment to such a proposal is the concern by some that it could create incentives for certain States to establish lenient requirements with the hope that producers might flock there for resident licenses. Such a "race to the bottom" would be detrimental to the goal of fair, responsible regulation. To address the concern, the draft proposal would empower the NAIC to establish minimum standards for licensure. Only agents or brokers licensed as a resident in states that satisfy these minimum standards would be able to benefit from the preemption of state licensing authority over non-resident agents. If an agent or broker resides in a state that does not adopt the minimum-licensing standards, the proposal would explicitly enable that producer to apply to a state in which they do business and that has adopted such minimum standards to be licensed as a resident. Through this mechanism, Congress also could dictate minimum licensing standards. Under the draft proposal, for example, the minimum licensing standards would be required to include the performance of a criminal background check, utilization of standardized licensing cycles and application forms and fees in the filing process, imposition of a standardized trust account requirement for use in any state that requires maintenance of such accounts, and the mandatory availability of agency-level licenses.

c. Company Licensing/Transaction Review/Corporate Governance/Insolvency Standards/Financial Audits

Like insurance agents and brokers, insurers currently must be licensed by every State in which they do business. They also must satisfy a variety of corporate organization, solvency and governance requirements and go through multiple reviews of proposed corporate transactions (i.e. change in control, mergers and acquisitions) and financial audits. Insurers need a single set of requirements; requisite compliance with the rules of multiple states creates delays and adds unnecessary costs without adding any tangible consumer benefit. Compliance with multiple audit procedures also is needlessly inefficient, costly and administratively cumbersome for insurers.

As in the insurance producer context, in developing potential solutions, the possibility of a race to the bottom and regulatory turf concerns of state insurance departments must be considered. In particular, state insurance departments likely will be hesitant to accept licensing, solvency and auditing determinations made by other States where the insurer does a significant amount of business in their States.

Regulation in this area also must contemplate the financial risks at stake if insurer solvency is not sufficiently regulated and companies become financially unsound. Concerns about possible strains on the guaranty system and the need for bailouts (such as in the savings-and loan-crisis) are never far from the surface when dealing with this area of regulation.

To remove duplicative and inconsistent requirements and examination procedures while at the same time maintaining sufficient protection for policyholders and the public, the proposal for companies tracks the producer licensing proposal by preempting the ability of all States to impose any licensing/transaction, review/corporate or governance/solvency standards or requirements on any non-resident company that is licensed by a State that is accredited by the NAIC. An insurer would be able to select as its "home state" either its State of domicile or its State of incorporation. States still would be free to require non-resident companies to be licensed but only upon proof of home-state licensure and the submission of a fee. The draft will clarify that any company that satisfies such federal "passport" requirements can offer products in a non-resident state even if the state does not try to license them through the federally approved process (if the state does license in a federally permissible way, an insurer would have to comply with the state requirements, however). Hence, although any State could impose more stringent requirements on its resident companies, the system would remain uniform from the perspective of each individual insurer because each insurer would need to comply with only one set of substantive requirements.

To stem a potential "race to the bottom," a company will be required to be licensed in an "accredited" state in order to use its license as a passport to do business in other states and have the preemption outlined above apply to its activities in those non-resident states. The legislation would empower the NAIC to continue to conduct the accreditation process, subject to two new requirements.

First, additional accreditation requirements would have to be incorporated into the NAIC's accreditation requirements, including the new producer licensing minimum standards and any company minimum licensing, solvency or other standards that Congress chose to incorporate.

Second, the NAIC's accreditation criteria and any determination that a State is (or is not) accredited would be subject to review and disapproval either by a federal agency or by a federal court. Such oversight would be limited to reviewing NAIC determinations regarding what standards must be satisfied to become accredited and applications of those standards to states that have applied for accreditation.

To ensure that no company would be penalized (and thus unable to qualify for the "passport" rights) by virtue of the fact that it is domiciled in a non-accredited state, the legislation would permit an insurer to choose an alternative state of "residence" for licensing purposes if its state of domicile and its state of incorporation both are not accredited. Tentatively, the legislation will allow such an insurer to be licensed in the accredited state in which it does the most business based on premium volume. This should increase the pressure on all states to become accredited.

The legislation also must account for the possibility that the NAIC will refuse to implement the program and/or that the States will decide to boycott the process. In either event, the legislation will incorporate the back-up provisions included in NARAB. Hence, either if the NAIC refuses to implement the accreditation procedures as required under the Act or if a majority of States do not become accredited within a specified number of years, an independent body would be established either to stand in the shoes of the NAIC in conducting the accreditation process or—if States refuse to comply—to act as a licensing clearinghouse so that insurers will qualify for the licensing/solvency/etc. single set of requirements envisioned under the overarching approach. The proposal utilizes a combination of the NARAB back-up provisions and the Risk Retention Act non-resident state regulatory provisions to create these fall-back sets of provisions. The tighter they are designed, the less likely it is that the NAIC and/or the States will refuse to comply with the intended NAIC accreditation procedures.

d. Market Conduct Examinations

Insurers are subject to examinations from insurance departments in multiple States. Exam procedures are inefficient and requirements are duplicative as a result of lack of coordination between States. Multiple exams are costly and administratively cumbersome for insurers. There often does not appear to be a sound justification for the examination and there are no restrictions on most insurance department's exercise of their market conduct examination power.

At the same time, however, it must be noted that market conduct directly involves consumer protection issues and, as a result, turf concerns and political concerns can be prevalent. Moreover, the focus of market conduct examinations is supposed to be on sales practices that occur where the customer is located rather than where the company resides, undermining the practicality of mandating a home-state regulation approach.

To reduce the administrative costs of compliance by clarifying the circumstances under which a regulator of a non-resident insurer may conduct examinations, the frequency with which such examinations may be conducted, and the review procedures that will apply, the proposal would require that, in the non-resident state, examinations may be conducted only to review compliance with properly promulgated statutory and regulatory requirements, and that no insurer can be deemed to have "failed" such an examination unless it is provided with an explanation in writing that sets forth the statutory and/or regulatory requirement that allegedly has been violated. The proposal includes a provision permitting any claim that a regulator is exceeding the scope of his or her authority to be brought in federal court.

In an effort to facilitate greater coordination of market conduct examinations where appropriate, the proposal includes a provision authorizing and encouraging the use of multi-state compacts to facilitate market conduct examinations.

Conclusion

Although IIABA supports the preservation of state regulation of the business of insurance, we believe that reforms to the current system are necessary and essential. Specifically, IIABA believes the best alternative for addressing the current deficiencies in the state-based regulatory system is a pragmatic, middle-ground approach that utilizes federal legislative tools to foster a more uniform system and to streamline the regulatory oversight process at the state level. By using federal legislative action to overcome the structural impediments to reform at the state level, we can improve rather than replace the current state-based system and in the process promote a more efficient and effective regulatory framework.

Rather than employ a one-size-fits-all regulatory approach, a variety of legislative tools could be employed on an issue-by-issue basis to take into account the realities of today's marketplace and to achieve the same level of overall reform as the imposition of a federal regulator. The specific ideas outlined above are just a few of the many specific solutions that could be adopted under this type of approach. Instead of relying on the agenda of a displaced and possibly politicized federal regulator, however, insurance regulation would continue to be grounded on a more solid foundation—the century-and-one-half worth of skills and experience that the States have as regulators of the insurance industry. The advantage of this approach is that it offers the best of all worlds. It will promote the establishment of more uniform standards and streamlined procedures from State to State, protect consumers while enhancing marketplace responsiveness, and emphasize that the primary goals of insurance regulation can best be met by improving, not abandoning, the state-based system that has been in place for over 150 years.

United States House of Representatives
Committee on Financial Services

"TRUTH IN TESTIMONY" DISCLOSURE FORM

Clause 2(g) of rule XI of the Rules of the House of Representatives and the Rules of the Committee on Financial Services require the disclosure of the following information. A copy of this form should be attached to your written testimony.

1. Name: Thomas B. Ahart, CPCU,AAI	**2. Organization or organizations you are representing:** Independent Insurance Agents & Brokers of America, Inc.
3. Business Address and telephone number: Ahart, Frinzi & Smith 2250 Belvidere Road Phillipsburg, NJ 08865 908-454-4170	
4. Have you received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2000 related to the subject on which you have been invited to testify? ☐ Yes ☒ No	**5. Have any of the organizations you are representing received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2000 related to the subject on which you have been invited to testify?** ☐ Yes ☒ No
6. If you answered "yes" to either item 4 or 5, please list the source and amount of each grant or contract, and indicate whether the recipient of such grant was you or the organization(s) you are representing. You may list additional grants or contracts on additional sheets.	
7. Signature: TB Ahart	

Please attach a copy of this form to your written testimony.

TESTIMONY OF
SCOTT A. GILLIAM
DIRECTOR OF GOVERNMENT RELATIONS
THE CINCINNATI INSURANCE COMPANIES

BEFORE THE

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE
AND GOVERNMENT-SPONSORED ENTERPRISES
OF THE HOUSE FINANCIAL SERVICES COMMITTEE

ON

REGULATION AND COMPETITION IN THE INSURANCE INDUSTRY

JUNE 18, 2002

Introduction

Good afternoon Chairman Baker, Ranking Member Kanjorski, and Members of the Subcommittee. My name is Scott A. Gilliam. I am Director of Government Relations for The Cincinnati Insurance Companies, headquartered in Fairfield, Ohio, just north of Cincinnati.

Our group of companies market property and casualty insurance and life insurance in 31 states through an elite corps of fewer than 1,000 local independent agencies. With nearly one million policies in force insuring businesses and families, our parent company, Cincinnati Financial, is among the 17th largest publicly traded property and casualty insurer based on 2001 revenues of $2.5 billion.

This is the third in a series of hearings by the Subcommittee to examine regulation and competition in the insurance industry. These hearings come at a time when the current system of insurance regulation is under scrutiny by insurance companies, regulators, agents, consumer groups, trade associations and Congress. A re-examination of the current system and the need for reform is necessary and healthy and I commend the Subcommittee for holding these hearings.

I was asked to talk about consumer protection issues and how they impact the question of whether insurance regulation should remain a state-based system or whether a Federal approach to insurance regulation should be considered. While consumer protection issues will be the anchor of my remarks today, I cannot avoid sharing my company's concern about the future of insurance regulation and those who seem poised to jump to a Federal system for a quick fix. Nor can I avoid sharing our long held belief that the states are in the best position to satisfy the public policy objectives of insurance regulation—to protect consumers by assuring the financial soundness and solvency of insurers, promoting competitive markets, and enforcing insurance laws.

Consumers Are Served Best By State Regulation

Consumers clearly have an enormous financial and emotional stake in ensuring that the promises made by insurance providers are kept. Collectively, the insurance premiums paid for property/casualty and life insurance products by American insurance consumers in 2000 amounted to over $730 billion. With numbers like these, the interests of insurance consumers must be at the forefront of the debate over state versus Federal regulation of insurance.

We believe the state insurance regulatory system has served insurance consumers well over the past 150 years. For consumers, the strengths of the state-based system of insurance regulation lie in its ability to respond to consumers, to adapt to local market issues, and to enable states to experiment and learn from each other. State insurance commissioners become experts in the individual state issues they face, enabling other commissioners to learn from their experience. In that way, the insurance regulatory system evolves to meet new challenges.

Accessibility is another advantage that state insurance regulation has over the Federal regulation insofar as consumers are concerned. No one can quarrel with the fact that it is easier to deal with regulators in the consumer's home state than by having to call Washington or contact a regional Federal office in order to get help with a consumer insurance issue.

The accessibility of insurance regulators to consumers would also suffer under an optional Federal charter system given the likelihood of consumer confusion with the two systems. Under an optional Federal charter system, state-chartered insurers and Federally chartered insurers would operate side by side in the states. Under those circumstances, consumer access to regulatory protection would become needlessly complicated by the mere existence of dual regulatory systems and the resulting confusion as to which system has jurisdiction over a particular consumer complaint. Protecting consumers during the sales process would be even more problematic, since many state-regulated agents would also be selling products offered by Federally chartered insurers, further complicating the question of which system has jurisdiction over a particular transaction. Insurance consumers should not have to roll the dice when deciding whom to contact for a problem.

The warning made by Chairman Oxley in his opening statement last week, that consumers can not be adequately protected if insurers are subject to conflicting requirements at the Federal and state levels, seems equally applicable to the situation insurance consumers would face with conflicting Federal and state consumer protection systems.

It is also doubtful whether the Federal government would have the resources and expertise necessary to effectively and efficiently protect insurance consumers. It would take a huge effort to duplicate the activity of the states in this regard. Consider these facts:

- In the year 2000, insurance consumers made approximately 4 million consumer inquiries and complaints to state regulators.

- State insurance regulators employ 12,500 regulatory personnel nationwide and spend $853 million annually to be the watchful eyes and helping hands on consumer insurance problems (2000 data).

The numbers are no less significant for Ohio, which handled over 126,000 insurance consumer inquiries regarding companies and agents last year. The Federal government is simply not equipped to take on such a role and develop a regulatory authority for insurance consumer protection as sophisticated and widespread as a state system that has been 200 years in the making. And as we have seen many times, Federal regulatory systems often become self-perpetuating and non-responsive to the needs of those they regulate and protect. To ensure effective consumer protection and consistent quality and dependability for the vast array of products now available in the insurance marketplace, state regulation should remain the only vehicle for protecting insurance consumers and regulating our good industry.

The Benefits of State Regulation to Insurance Companies Also Benefit Insurance Consumers

The benefits of the state insurance regulatory system on insurance companies also translate into benefits for insurance consumers in the form of competitive markets. Consider the following attributes of state-based insurance regulation which ultimately benefit consumers:

Unique knowledge of the markets and local conditions. The states are the only logical choice for the comprehensive regulation of insurance given their unique knowledge of local markets and conditions. State regulators know the insurance markets within their borders. Although there are uniform national concerns in this industry, as in many others, in uncountable ways insurance involves concerns of an intensely local nature. The concerns in Ohio, for example, with its multiple urban centers, lake-front communities, and manufacturing base, are quite different from the insurance issues raised in Iowa, with its thousands of farmers and few large urban areas.

Less risk of regulatory mistakes. Under state regulation, good regulatory initiatives spread to other states and, conversely, the bad ideas tried in one state prevent others from making the same mistakes by offering real-market examples. Having fifty different regulators is less risky than gambling on a single Federal regulator who might have an axe to grind against the insurance industry—and ultimate power over the industry to swing the axe.

Anti-competitiveness. Federal regulation will create an unlevel playing field between those insurers who opt for Federal regulation and those whose insurance activities continue to be regulated by the states. With two completely separate and uncoordinated systems of regulation, there will be no uniformity in the forces and pressures competing insurers face as a result of regulatory oversight. With separate and competing systems of rate and form regulation, underwriting requirements, market conduct regulation, insolvency requirements, and other critical aspects of insurance regulation, another unnatural force will enter the insurance marketplace: choice of regulatory scheme (state or Federal). That will result in an unfair and anti-competitive distribution of market advantages and disadvantages based on choice of regulatory system, and it will destroy the level playing field on which our industry now competes.

The risk of a Federal advocate. Some argue that the insurance industry needs a Federal regulator who will fight for our interests against other financial institutions and advocate our views before Congress, just as the Securities and Exchange Commission and the Office of the Comptroller of the Currency champion the securities and banking industries. But consider the other face of Federal regulation: a single Federal regulator with ultimate power over an industry and an axe to grind. And as we have seen many times before, Federal regulatory systems often become self-perpetuating and non-responsive to the needs of those they regulate.

Flexibility. The attributes of an ideal insurance regulatory system include reasonableness, flexibility, adaptability to local markets, regulator expertise, and the ability to spread the risk of bad regulation. Federal regulation cannot compete with state regulation in these areas.

State regulation encourages innovation. Insurance companies often use a particular state as a laboratory for testing new product ideas or competitive strategies before they are introduced on a national level. Good products and good competitive strategies in one state often spread to other states. Likewise, unsuccessful strategies in one state often educate the rest of the industry and lead to better products and more competitive markets in other states.

New Federal bureaucracy. At a time when Congress is seriously considering empowering states in a myriad of areas, Congress should not strip the states of their authority to regulate in a business arena that has been within their virtually exclusive domain throughout this country's fruitful history. The last thing America needs is another Federal bureaucracy.

Modernizing And Streamlining State Regulation To Reflect The Changing Face Of The Industry

Since 1945, the insurance industry in the United States has been regulated by the states under authority of the McCarran-Ferguson Act. While state regulation of insurance has worked very well, the realities of changing market conditions, including globalization, financial services convergence, and consolidation, demand a more efficient regulatory system, including greater coordination and consistency across states.

While some are calling for Federal regulation to address the changing face of the insurance industry, we feel state regulation still works best. At the same time, we realize that in order to preserve state regulation during these changing times, the current system of state-based insurance regulation needs to be modernized, streamlined, and made more efficient.

A strong and growing effort is already underway within the National Association of Insurance Commissioners ("NAIC") to modernize state insurance regulation and a national regulatory agenda appears to be taking hold. In March 2000, the NAIC recognized that the realities of changing market conditions, including globalization, financial services convergence, and consolidation, demanded a more efficient regulatory system, including greater coordination and consistency across states. The NAIC responded by laying out its vision for the future in the unanimously adopted "Statement of Intent: The Future of Insurance Regulation," explaining as follows:

> "Fueled by enhanced technology and globalization, the world financial markets are undergoing rapid changes. In order to protect and serve more sophisticated but also more exposed insurance consumers of the future, insurance regulators are committed to modernize insurance regulation to meet the realities of an increasingly dynamic, and internationally competitive financial services marketplace. This will include working with all parties to combat and reduce the incidence of fraud, thereby providing a safer environment for consumers and lower costs.
>
> "We pledge to work cooperatively with all our partners – governors, state legislators, Federal officials, consumers, companies, agents and other interested parties – to facilitate and enhance this new and evolving marketplace as we begin the 21st Century."

Since the issuance of its Statement of Intent, the NAIC has been working to refine its vision for regulatory modernization through the development of detailed proposals to streamline the state insurance regulatory system. Confident in its belief that functional insurance regulation at the state level is the best insurance regulatory system, and showing commitment to its charge to protect consumers, keep insurers and producers accountable, and maintain a sound and non-discriminatory insurance regulatory system in the United States, the NAIC is already making significant progress in several critical areas of regulation. These include:

- promulgation of a uniform producer licensing model act and passage of the act or other uniform licensing laws by 46 states with the intent of satisfying the reciprocity licensing mandates of GLBA's NARAB provisions

- several speed to market initiatives, including a system for electronic rate and form filing, the implementation of rate and form filing checklists and review standards in forty-four jurisdictions to speed product approval, and two initiatives to create a single point of filing for new life, health and annuity products (an interstate collaboration initiative and the coordinated advertising, rate and form review authority)

- several initiatives to create uniformity in company licensing and corporate governance (the uniform certificate of authority application and the "national treatment" initiative)

- an initiative to coordinate the review of holding company transactions that impact insurance subsidiaries domiciled in multiple jurisdictions

- an effort to institute a "lead state" framework for financial regulation

- promulgation of uniform privacy laws and regulations and the passage of new privacy protection laws and regulations in forty-nine states and the District of Columbia to GLBA requirements

- several initiatives to enhance consumer protection, including an interactive web tool specifically created for consumer research of company complaint and financial data

- several initiatives to build a more effective and nationally coordinated market conduct and regulation system

We would be remiss if we did not acknowledge that these efforts by the NAIC to modernize state insurance regulation are only a start. Virtually every area of insurance regulation needs to be improved if the state-based system is to meet the challenges of a modern insurance market. But unlike those companies who would abandon the state-system and start over with Federal regulation or dual regulation, The Cincinnati Insurance Companies are committed to doing the hard work needed in the state capitols to modernize, streamline and increase the efficiency of state regulation, and preserve its use as the preferred method for insurance regulation and consumer protection.

We believe the road to regulatory reform runs through state capitals, not through Washington, D.C., and in the end insurance consumers will be the ultimate beneficiaries of this approach to reform.

Using Congressional Action To Encourage Regulatory Modernization In The States

While we believe Congress should defer action on optional Federal insurance charter legislation until the states have had a fair amount of time to institute the necessary reforms themselves and modernize, streamline and increase the efficiency of state regulation, we realize the states may need encouragement to carry the ball into the end zone. While state regulators and the NAIC can recommend standards for reform and raise the profile of important reform issues, we realize that they cannot act alone. They need state legislators and governors to engage in the process and enact the fundamental insurance regulation reforms necessary to modernize state insurance regulation in the 50 states.

But what if the states do not follow the lead of state insurance regulators and the NAIC and enact the reforms needed to modernize, streamline and increase the efficiency of state regulation, or do not act soon enough or do enough to reinvigorate state insurance regulation? In this event, we are intrigued by the possibility of using Federal legislation to encourage the states to undertake more rapid and comprehensive reform of state insurance regulation. While we are as yet undecided on the form such legislation should take, we would prefer a model that would allow the NAIC to be active in crafting the reform legislation states would need to enact to avoid Federal regulation.

We would also suggest that Congress avoid the use of a one-size-fits-all approach and instead consider a variety of legislative tools which could be employed on an issue-by-issue basis to take into account the realities of today's changing marketplace.

In suggesting that Congress consider the use of Federal legislation to encourage reform at the state level, we are mindful of the dangers incumbent in opening these issues up for Federal legislative debate. For example, a piece of legislation originally drafted for relatively narrow reasons could result in expansive new demands and expectations on the industry. While we recognize these dangers and are concerned about them, we believe that using Federal legislation to encourage reform at the state level as a last resort is certainly better than jumping hook, line and sinker into a Federal system of insurance regulation.

State Regulation Is The Preferred Method Of Regulation For All Lines Of Insurance

Many in the industry only think of my company as a property and casualty insurer. However, we do have a significant life insurance operation, the Cincinnati Life Insurance Company, which generated gross premium volume of $122 million in 2001. In fact, the Cincinnati Life Insurance Company is a former member of the American Council of Life Insurers.

I bring this to your attention in reply to the growing refrain in Washington that life insurance is different from property and casualty insurance in several critical ways which make it better suited for federal regulation than property and casualty insurance. Some even seem to think that we should not think twice about lobbing off the life industry and handing it over to federal regulators.

My company strongly disagrees with this point of view and believes that state regulation works best for all aspects of the industry, including life insurance as well as property and casualty insurance. We want to see state insurance regulation modernized, streamlined and made more efficient for all lines of insurance and will do all we can to achieve this goal. A reformed system of state insurance regulation for all lines of insurance, including life, is far superior to an unproven system of Federal regulation.

Conclusion

For those who support Federal regulation or an optional Federal insurance charter, it is easy to argue in favor of Federal involvement, since the debate is mostly hypothetical. But when one compares any hypothetical Federal system with the system of state regulation already in existence, together with the improvements in state regulation already underway, the benefits of the state system for consumers and the industry far outweigh any perceived advantage of a Federal system.

TESTIMONY OF

WAYNE E. McOWEN, SENIOR VICE PRESIDENT

FOR GOVERNMENT AFFAIRS AND INDUSTRY RELATIONS

GUARD FINANCIAL GROUP

ON

"Insurance Regulation and Competition for the 21st Century"

BEFORE THE

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND GOVERNMENT SPONSORED ENTERPRISES

OF THE

COMMITTEE ON FINANCIAL SERVICES OF THE

UNITED STATES HOUSE OF REPRESENTATIVES

18 JUNE, 2002

Chairman Baker, Ranking Member Kanjorski and members of the Subcommittee, my name is Wayne E. McOwen and I am Senior Vice President for Government Affairs and Industry Relations for Guard Financial Group, headquartered in Wilkes-Barre, Pennsylvania. I thank you for the opportunity to offer commentary on the Optional Federal Charter for insurers, and I join my industry colleagues in applauding your diligent and enthusiastic commitment to the issue of insurance regulation reform.

GUARD Financial Group (GFG) is a corporate holding company for the following insurance, banking and investment operations: GUARD Insurance Group (GIG), a Workers' Compensation specialist that provides coverage and an extensive array of customer services to businesses through three insurance affiliates licensed in 27 jurisdictions including the District of Columbia; GUARD Security Bank (GSB), a federally chartered thrift and a "virtual" operation that uses electronic communications -- in lieu of branches -- to enhance service, reduce overhead and provide the most competitive products to its customers; and GUARD Capital, which facilitates entry into the sale of investment products by guiding producers through the licensing and compliance process.

As the nature of these enterprises suggests, our organization is subject to both state and federal regulation. Over the past several years, the expansion of our insurance operations has provided first-hand experience with regulatory processes in multiple states. Enabled by Gramm-Leach-Bliley, our organization's entrée to banking required considerable interaction with the Office of Thrift Supervision (OTS) in the chartering of GSB. My purpose today is not to defend or advocate one system of regulation over the other; but, rather, drawing on these contemporary experiences, to offer observations that may provide insights into the advantages of choice.

As requested, my comments will be in two parts: 1) Observations on the regulation of insurer business practices, or Market Conduct as it is known in the industry; and, 2) Reflections on regulatory choice and regulatory competition – why the coexistence of state and federal regulators could make sense for insurance segments of the financial services industry to the advantage of all stakeholders.

MARKET CONDUCT CONSIDERATIONS

State regulators focus on two primary aspects of insurance company operations: financial viability and general business practices. Oversight of these areas is achieved by a process of examinations. The intent is to identify variances from established standards and recommend appropriate remedial action where necessary.

Financial examinations scrutinize and monitor insurer solvency, the primary public policy objective of insurance regulators. A series of defined ratios serve as an early warning system to identify potential problems. Examiners screen for adherence to risk-based capital requirements, strict investment policies, and statutory accounting principles among other financial standards. The process is as precise as mathematics.

A market conduct examination is the mechanism by which insurers' general business practices are evaluated. Whereas all states focus on the **objective** components of an insurer's financial health, the evaluation of insurer business practices is neither universal nor uniform and, therefore, can be somewhat **subjective**. However well intended, under these circumstances, such provisions are of limited benefit to consumers and of maximum concern for the industry.

State insurance statutes contain provisions aimed at preventing unfair or deceptive practices, restricting unfair competitive practices, prohibiting activities that are arbitrary or capricious in the administration of policies and fraud. Definitions of prohibited activities can vary widely. For example, what constitutes "fair" treatment of policyholders and claimants, or what might be considered to be "arbitrary" or "capricious" insurer action, is open to varying interpretations from one jurisdiction to another – sometimes from one examiner to another. Examiners may be regulatory staff, or, in some instances, the process is outsourced by regulators to contract examiners. That consumer protections have been and continue to be a priority of state insurance regulators is unquestionable. It is also true, however, that inconsistencies among jurisdictions can make the process complex and unnecessarily costly, ultimately limiting the benefits to stakeholders.

Even when statutory wording is identical, the interpretation of regulations can vary from jurisdiction to jurisdiction. Carriers doing business on a multi-state basis are faced with the necessity of filing (and often re-filing) products in multiple variations to satisfy even the most modest differences in regulatory requirements in order to receive approval to market their products. This has engendered the need for insurers to create dedicated units staffed with compliance specialists to monitor and respond to the individual requirements of each state in which the carrier is approved to conduct business. Carriers may also find it necessary to engage external consultants to provide ad hoc regulatory requirement compliance assistance, resulting in additional fees for services and further raising the costs of doing business.

In some instances, it is not the interpretation of the requirement but the variations of that requirement that become problematic – particularly when benchmarks, against which carrier performance is measured, differ for no apparent reason. One example is in the area of cancellation notification. Although it might seem that adherence to time specific notification requirements should not be onerous, it can be. For instance, all jurisdictions have statutory notice requirements regulating coverage cancellation, and insurer adherence to these provisions is one area monitored by regulators. Such provisions vary from requiring as few as ten days to thirty days to as many as forty-five days notice to policyholders and/or to other stakeholders, such as a mortgagee. However, there is no clear rationale for why the policyholders of one state are accorded a thirty-day notice, while those in another state receive only ten days. Although individual insurance consumers relocating from one state to another may be confused when they encounter these inconsistencies, a far greater problem is created for commercial policyholders engaged in multi-state operations. They must continually adjust their own business practices to keep up with how their insurance providers are required to deal with them on such issues. If the United States Postal Service were unable to provide consistent mail delivery from state to state, then differing requirements for the delivery of cancellation notices might be more readily understood. However, we know that, with the possible exception of service to certain remote areas, the delivery of mail is standard countrywide. For insurance carriers doing business in multiple states, and especially for those offering multiple lines of insurance, the patchwork of notification mailing requirements makes complex what might otherwise be a simple process, raising the cost of doing business to the detriment of the consumer.

The existence of uncodified procedures, sometimes referred to as "desk drawer" regulations, is also problematic for carriers. These unpublished and unpredictable procedural requirements can have significant consequences in terms of a carrier's eligibility to become a new entrant in a state or to offer new products and services.

Inconsistency and fragmentation is also evident in the application of standards among different lines of business, personal and commercial, as well as in the application of regulations for a single line of business, both in multi-state scenarios and within a single state. For Workers' Compensation, for example, the responsibility for business practices oversight may reside in more than one state regulatory agency. In some jurisdictions, those policyholder issues are the focus of the Department of Insurance, while claimant issues are the focus of a Workers' Compensation Commission under the Department of Labor. Whether or not policyholders and claimants always share a common interest in the application of Workers' Compensation coverage, when two agencies in one state share regulatory authority, outcomes can be unpredictable.

Additionally, the Market Conduct process is, by design, duplicative. Carriers are subject to scrutiny by the insurance department of their state of “domicile,” as well as by the regulators of every state for which a license to do business has been granted. All exams are conducted at carrier expense. Exam conducted by the domestic regulator may be duplicated by other states’ regulators as they evaluate the identical business practices. This presents a high cost of doing business for carriers, not only in terms of multiple exam fees but in the downtime of staff assigned to working with examiners.

Ultimately, although multi-state insurers have become as fully engaged in interstate commerce as any bank or other financial enterprise, unlike these other segments of the financial services industry, insurers continue to be regulated by more than fifty individual systems with nearly as many sets of proprietary rules and procedures. For more than 100 years, a dual regulatory system has worked successfully for banking institutions. It is time to consider the potential advantages of that model for certain insurance operations and allow insurers -- and their customers – all of the benefits derived from choice.

OPTIONAL FEDERAL CHARTER: A MATTER OF CHOICE

Choice: America was founded on it! Competition: America thrives on it! Why then is the prospect of regulatory choice for insurers and the resultant competition between state and federal regulators so difficult to accept? Is the insurance segment of the financial services industry so different, so less a factor in our economy that any measure of federal oversight is unnecessary or unwarranted?

Admittedly, an optional federal charter does not have universal appeal, but the operative word in the application of such a concept is “optional.” For insurers doing business in the multi-state arena, or for those who market a limited number of products with risk factors that are consistent from state-to-state, the advantages of streamlining the regulatory process under a federal charter could be many. Ultimately, those advantages would inure to the benefit of consumers in terms of a carrier's ability to introduce a wider selection of more innovative and competitive offerings. Simply stated, a choice for insurers translates to more choices for consumers.

Our economy thrives on competition and on the entrepreneurial spirit that has brought innovative and exceptional products to the market. Much work has been accomplished by states toward uniformity and consistency under the direction of the National Association of Insurance Commissioners (NAIC). The NAIC is to be commended for its leadership and its resolve. But, the process proceeds at what some observers have characterized as glacial speed, the victim of the continuing resistance by some states to accept alternative applications of regulatory concepts and regulatory priorities in conflict with their own. Without an impelling incentive, the process of crafting meaningful regulatory modernization among the states can be expected to continue to move slowly. Can we afford to wait and risk the consequences? There are compelling reasons to act now:

- An expanding global economy demands a unified approach to our participation in the international insurance arena.

- Our complex and overburdened legal system strains to serve an increasingly litigious society, pressuring an insurance industry disadvantaged by the inconsistent rules and regulations under which it must operate.

- The option of employing the internet to make viable insurance products available to consumers via e-commerce demands uniform insurance laws and the immediacy of consistent interpretation enabled by federal regulation.

- Federal initiatives, such as the "Patients' Bill of Rights" and the potential impact on Workers' Compensation coverage of pending HHS medical privacy rules are examples of issues that bolster arguments for considering centralized versus de-centralized regulatory authority in certain circumstances.

- The insurance industry acted with dispatch in response to the September 11th tragedy. A critical component of our preparedness and resolve to deal with the far-reaching and extraordinary challenges of possible further terrorism events illustrates the key role of the federal government. Stakeholders did not approach fifty states for a solution to terrorism insurance, they went directly to Washington.

This is not to say, as some critics would suggest, that it is necessary to "reinvent the wheel" to shift from exclusively state regulation to a system that introduces a federal component. Providing the insurance industry with a strong voice in Washington is not intended to either replicate or replace all state regulatory authority. Ideally, federal and state regulatory authority would be neither exclusionary nor duplicative but simultaneous and complementary.

Where to look for the components of federal regulation is obvious: the best practices of the state regulatory system. Discussions aimed at achieving uniformity among states default to best practices considerations in crafting model laws intended to encourage uniformity. But, **encouraging** it is not the same as **requiring** it! The creation of appropriate federal policies, based on existing state model laws, coupled with the creation of appropriate new federal policies, would require the broadest and most immediate application of such policies. A federal regulator would have the tools to make it happen.

The Founding Fathers were judicious in crafting a federal umbrella that would not impair states' rights. Their goal was to strengthen a system of individual state mandates by bringing structure and unity. More than two centuries later, we struggle with this concept in terms of its application to the regulation of insurance – a mechanism that the tragedy of September 11th confirmed is critical to our economy and to our lives.

AMERICAN BANKERS
INSURANCE ASSOCIATION
An affiliate of the
AMERICAN BANKERS ASSOCIATION

Statement of Glen Milesko

On Behalf of the

American Bankers Insurance Association

Before the

Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises

Of the

Committee on Financial Services of the

United States House of Representatives

June 18, 2002

Mr. Chairman and Members of the Subcommittee:

My name is Glen Milesko, and I am the President and Chief Executive Officer of Banc One Insurance Group. I am here today on behalf of the American Bankers Insurance Association ("ABIA").[1] My testimony today also reflects the views of the American Bankers Association.

ABIA's members are banking organizations, insurance companies and third party administrators engaged in the business of insurance. Banc One Insurance Group, for example, is one of the nation's leading bank providers of insurance. It is comprised of a nationally licensed, full line insurance agency with over 5,000 licensed agents; a multi-state insurance agency, a life insurance company, one life and two property and casualty reinsurance companies; one multi-state direct credit life insurance company; and an international life reinsurance company located in Dublin, Ireland.

ABIA Supports Optional Federal Insurance Chartering

ABIA appreciates the opportunity to appear before the Subcommittee as it examines the regulation of insurance and the option of federal chartering for insurers and

[1] The American Bankers Insurance Association (ABIA) is a separately chartered trade association and non-profit affiliate of the American Bankers Association representing more than 250 of the nation's largest banks and insurers. ABIA's mission is to develop positions and strategies on bank-insurance related matters, represent those positions before state and federal governments and in the courts, and support bank-insurance related programs and activities through research, education and peer group information sharing.

producers. Over four years ago, ABIA developed its own "blueprint" for the optional federal chartering of insurers and producers. That blueprint called for the creation of an insurance regulatory system patterned after the dual banking system.

We believe that any insurer and any producer should be able to voluntarily choose to be regulated either by the Federal Government or by state governments. Such a system is not intended to replace state regulation – but to be an alternative to state regulation. This option has worked well in the banking industry, and we see no reason to believe it could not work well in the insurance industry.

When we first developed our blueprint, Congress was actively debating the Gramm-Leach-Bliley Act. Therefore, we put the blueprint on the "back burner" until action on that bill was complete. Once the Gramm-Leach-Bliley Act was finalized, we made optional federal chartering a priority for our Association. We converted our blueprint into a specific legislative proposal, and unveiled it at a conference organized by the American Enterprise Institute.

As you might expect, our proposal received a mixed reception. While the proposal received some quiet encouragement from certain sections of the insurance industry, it was roundly criticized by several insurance trade groups and state insurance regulators. Also, some in the insurance industry wondered why a banking association was concerned about insurance regulation. The fact is that the banking industry is actively engaged in the business of insurance. As of year-end 2001, there were approximately 1900 banking institutions engaged in the business of insurance, mostly through agency operations. The total premium volume for insurance policies and annuities sold by those institutions was approximately $50 billion. It was through this involvement in the business of insurance that ABIA's banking members concluded that state insurance regulation was not suitable for all insurers and producers, especially those firms engaged in activities in multiple states.

It is now apparent that ABIA's concerns are widely held. The leading trade associations for property and casualty insurers and the life insurers also have developed proposals for optional federal insurance chartering. While their proposals reflect concerns unique to their respective organizations, the similarities between our proposal and their proposals are striking. Their proposals, like ours, are designed to permit insurers to voluntarily select a single regulator and a single set of regulations, rather than 55 regulators and 55 different sets of rules.

Given this convergence of interests, ABIA recently joined with the American Council of Life Insurers and the American Insurance Association - under the umbrella of the Financial Services Coordinating Council - to develop a common optional federal chartering proposal. The first step in that cooperative effort was the development of a set of principles, around which any legislative proposal should be structured. The principles provide for the establishment of a federal insurance regulatory authority within the Treasury Department that would be headed by a person appointed by the president and confirmed by the Senate for a fixed term. This regulatory authority would regulate exclusively federally chartered insurers and producers. State chartered insurers and producers would continue to be regulated by state regulators. Federal insurers and producers, not taxpayers, would be responsible for the ongoing costs of federal supervision and regulation. A copy of the joint principles is attached to my statement and a more detailed discussion of them can be found in the Statement by the Financial Services Coordinating Council that also is being presented today.

Consumer Protections and Optional Federal Chartering

You have asked that ABIA specifically address how optional federal chartering would affect consumers. We are pleased to do so. ABIA's member companies are driven by the needs and demands of consumers, so we recognize that any optional federal chartering proposal must be responsive to those needs and demands.

ABIA believes that optional federal chartering will benefit consumers in three primary respects:

- *It will assure consumers access to sound insurance products with consistent consumer protection standards;*
- *It will be responsive to the changing needs of consumers; and*
- *It will create a dynamic tension between state and federal regulators that is in the best interests of the consumers of insurance.*

The remainder of my statement discusses each of these consumer benefits.

Optional Federal Chartering Will Assure Consumers Access to Sound Insurance Products with Consistent Consumer Protection Standards

Optional federal regulation of insurers and producers can fully and fairly protect the rights and interests of the consumers of insurance through the establishment of federal solvency and market conduct standards.

Federal Solvency Standards

ABIA believes that any optional federal chartering bill should require federally chartered insurers to meet strict solvency standards. For example, federally chartered insurers should be required to meet risk-based capital standards, which ensure that federal insurers are adequately capitalized and which impose sanctions on federal insurers that fail to meet applicable capital standards; to follow investment standards, which require a federal insurer to invest assets prudently and which place quantitative limits on investments in subsidiaries engaged in activities not permissible for the insurer; and to comply with dividend restrictions, which prevent insolvent federal insurers from paying dividends. Such federal solvency standards would give consumers confidence that a federally chartered insurer will be able to pay claims on its policies.

The federal insurance regulator also should be given adequate authority to enforce compliance with federal solvency standards. This should include the authority to require federally chartered insurers to file regular reports on their operations and financial condition; the authority to regularly examine federally chartered insurers, and to the extent appropriate, their affiliates; and the authority to initiate an enforcement action against federally chartered insurers that fail to comply with applicable standards. Such enforcement powers should be patterned after those available to federal banking regulators, which include the power to remove officers and directors and to impose civil money penalties of up to $1 million a day.

The combination of federal solvency standards backed by regular examinations and enforcement actions would signal to consumers that federally chartered insurers are safe and sound.

Federal Market Conduct Standards

Federally chartered insurers — and federally licensed producers — should be subject to federal market conduct standards. Such standards would protect consumers by preventing unfair methods of competition and unfair and deceptive acts and practices in the advertising, sale, issuance, distribution and administration of insurance policies.

Critics of optional federal chartering often claim that a federal insurance regulator would not be able to adequately police sales and claims practices by federal insurers or producers. Some of these critics even cite the hundreds of thousands of consumer complaints filed annually with state insurance regulators in support of this claim. Federal regulation of the banking industry shows, however, that federal agencies can effectively enforce consumer protection standards.

Today, thousands of banks are offering a variety of products to consumers through hundreds of thousands of branches, ATMs, loan production offices and other outlets throughout the United States. These banks are subject to federal consumer protection statutes such as the Truth-in-Lending Act, the Truth-in-Savings Act, the Fair Credit Reporting Act, and the Equal Credit Opportunity Act. The federal banking agencies, which are responsible for enforcing compliance with these various consumer protection laws, have been able to fully and effectively enforce compliance with the laws. They have done so through a combination of regular examinations and the threat of enforcement actions. Federal market conduct standards for insurance monitored through regular examinations and the potential for significant enforcement action should work equally well for the consumers of insurance.

In fact, the combination of federal market conduct standards monitored through regular examinations and the potential for enforcement actions should provide insurance consumers better protection than currently exists in many states. The number of consumer complaints filed annually with state insurance commissioners is not a sign of successful state market conduct regulation. Those complaints indicate that something is wrong with state market conduct regulation — otherwise consumers would not need to file so many complaints. The fact is that several states do not conduct market conduct examinations, especially of producers, and this allows certain insurers and producers to engage in practices that are harmful to consumers. Additionally, since there is no central licensing and registration, "rogue" insurers and producers can move from state to state undetected. A recent example is the Frankel case, which allowed an unscrupulous individual to defraud several state regulators and embezzle $200 million before being detected. Federal market conduct standards, regular examinations and the threat of enforcement actions would effectively deter such harmful practices.

One so-called consumer protection that should **NOT** be part of any optional federal chartering proposal is rate regulation. As a general rule, we believe that consumers will be better served if federally chartered insurers are not subject to price controls. Price controls may be appropriate in non-competitive markets. In such situations, a single firm or a group of firms may be able to set and hold prices at unreasonable levels. The insurance industry, however, is a competitive industry. There are thousands of insurers operating in the United States, and there are no significant barriers to entry for new companies. In such a competitive market, competition between firms will protect consumers from unfair pricing schemes.

The consumer benefits associated with competitive rates are more than just speculative. Several states already have moved away from rate regulation, and, in those states, there is evidence that rates have fallen on certain products. For example, a recent study by Scott Harrington for the AEI-Brookings Joint Center for Regulatory Studies entitled "Insurance Deregulation and the Public Interest" found that auto insurance is less costly and more available in 14 states that do not require prior approval of rates than in 27 other states that do require prior approval.

We do not suggest, however, that any optional federal chartering proposal leave the matter of rates entirely to market forces. We recognize that even in the most competitive of markets, price collusion can exist. Therefore, ABIA supports the application of federal anti-trust laws to federally chartered insurers. The application of these laws would guarantee that rates are set fairly by market forces.

Also, we recognize that the problem for many consumers is not cost, but access. Some consumers cannot obtain needed insurance at any price. The states have adequately addressed this issue through the establishment of so-called "residual" insurance programs, which require insurers to provide certain categories of property and casualty coverage, such as auto and homeowners insurance, to consumers who cannot obtain such insurance in the open market. Federally chartered insurers that write such policies should be required to participate in such state programs, subject to all applicable state rules, including rate limitations.

Optional Federal Chartering Would Be Responsive To the Changing Needs of Consumers

In addition to providing consumers with sound products in a fair manner, optional federal chartering will meet the changing needs of consumers by giving them access to new and more uniform products. Under the current state system of insurance regulation, it can take months, if not years, for a company to introduce a new product in every state. Such delays are an inevitable result of a system in which every state has an opportunity to review and approve insurance products. With a single federal insurance regulator, however, it would be possible for a federally chartered insurer to introduce a new product without delay. This will enable federal insurers to design new products as the needs of consumers change.

Additionally, optional federal chartering would allow new products, and the delivery of those products, to be more uniform. For example, under an optional federal chartering system, the same life insurance policy could be offered in every state.[2] Similarly, it would permit a company to use the same policy form, same disclosure statements, and same administrative procedures throughout the United States. Uniform

[2] We assume, however, that even with an optional federal charter there could be state-by-state variations in property and casualty policies consistent with applicable state law.

policies and sales practices would reduce consumer confusion, especially for those consumers that move from state to state for professional or personal reasons. An added benefit of uniform administration of insurance products on a national basis is that companies can achieve greater economies of scale thereby reducing costs to the insurer, which can be passed on to the consumer.

Having a federal regulator would also provide for swift responses to consumer needs during times of crisis, such as the recent terrorist attacks or during a natural disaster. A federal regulator could respond with "one voice" rather than relying upon 55 separate regulators to collectively agree to a solution.

Uniform regulation also will facilitate delivery of insurance products over the Internet. As we all know, the Internet can reach consumers, regardless of where they are located. To date, however, the use of the Internet to deliver insurance products has been complicated by variations in state insurance sales laws. A single federal sales practice standard obviously would not be subject to such complications and, thereby, would expand consumer access to insurance products through the Internet.

<u>Optional Federal Chartering will create a dynamic tension between state and federal regulators that is in the best interests of the consumers of insurance</u>.

The commonly agreed upon model for optional federal chartering is the dual banking system. Under that system a bank can voluntarily choose either state or federal regulation. Since the dual banking system has been in place for over 135 years, the best way to judge how optional federal chartering for insurers and producers would affect consumers of insurance is to take a closer look at the dual banking system. A discussion of the dual banking system and the benefits it has brought to banking regulation and supervision is attached to my statement.

It is interesting to note that the authors of the dual banking system were President Lincoln and his Secretary of the Treasury, Salmon Chase. Apparently, Lincoln, as a young man, recognized that a national banking system was important to the economy. Therefore, after he became President, he worked with Secretary Chase to secure enactment of the National Bank Act, which provided for the chartering and regulation of national banks.

While there is evidence that President Lincoln intended national banks to replace the then existing system of state banks, that has not been the case. Today, approximately two-thirds of all banks are state-chartered, and those banks control approximately 40 percent of all banking assets. Therefore, contrary to the concerns of state insurance regulators, optional federal regulation will not replace state regulation.

Moreover, the dual banking system has created a healthy tension between state banking departments and their federal counterparts, including the Comptroller of the Currency. This healthy tension has stimulated the development of new products and services for consumers and new and better supervisory techniques by both state regulators and the OCC. It has also fostered more efficient supervision as the respective regulators vie to keep their costs of regulation reasonable. Said another way, the dual banking system has not precipitated a race to the bottom in regulation.

Critics of optional federal chartering will, nonetheless, cite the savings and loan crisis as a failure of the dual banking system. We would not attempt to defend that scandal. We would suggest, however, that the causes of the savings and loan crisis are many and complex. More importantly, following the savings and loan crisis, Congress passed two laws, the Federal Deposit Insurance Corporation Improvement Act (FDICIA) and the Financial Institutions Regulatory Reform and Enforcement Act (FIRREA), to redress deficiencies in the regulation of state and national banks and savings associations, and we assume that any optional federal chartering bill that is considered by Congress will incorporate many of those safeguards.

In sum, we see no reason to believe that the dynamic tension inherent in a dual regulatory system would not produce a strong supervisory environment for insurance firms and lead to the development of new products and services for insurance customers, just as it has done for the banking industry and banking customers.

National Standards

Finally, I would like to make an observation on one alternative to optional federal chartering, the creation of federal standards to be applied by the individual states. This concept could take two forms, neither of which is preferable to optional federal chartering.

On the one hand, federal standards could serve as minimum standards for the states, permitting states to layer further regulation on top of those mandated by the federal government. Under this scenario, federal standards would fail to achieve the uniformity and efficiency of regulation sought by ABIA and other advocates of optional federal chartering. In fact, minimum federal standards only would exacerbate the current patchwork of differing laws with which insurers and producers have to deal by merely adding another layer of regulation to the existing balkanized system of state regulation.

On the other hand, federal standards could be mandatory and exclusive. As such, the federal standards would not be an alternative to state regulation; they would replace state regulation. This alternative would intrude on the states to a much greater degree than an optional federal regulator which would leave state regulation untouched and the state system to its own devices. Instead of creating regulatory alternatives brought about by an optional federal charter and the healthy dynamic such alternatives engender, mandatory federal standards would spell the demise of state regulation, a result the critics of optional federal chartering are trying to avoid.

Summary

In closing, I wish to again thank you for the opportunity to appear here today. This is an important issue for the members of ABIA, and if we can be of any further assistance to you as you consider optional federal charters, I hope you will call upon us.

FSCC

Financial Services Coordinating Council

Representing America's Diversified Financial Services Community

Principles for Federal Insurance Regulation

The Financial Services Coordinating Council was formed by the four principal trade associations representing the major financial sectors of the U.S. economy to address issues of common concern at both the federal and state levels.

Its members are the American Bankers Insurance Association/American Bankers Association, American Council of Life Insurers, American Insurance Association, and Securities Industry Association. These organizations represent thousands of large and small banks, insurance companies, agencies and agents, and securities firms that, taken together, provide financial services to virtually every household in America.

Given the national and international market for insurance products, the time has come to provide a federal option for the chartering and regulation of insurance firms. The lack of regulatory uniformity, coordination and responsiveness in the state-based insurance regulatory system is unnecessarily costly and burdensome and has resulted in negative competitive implications for insurance companies, insurance agencies, and their customers. The securities and banking industries have long been subject to regulation by the Federal government, which is designed to protect the interests of consumers, regardless of where a product is sold or where the consumer resides. The federal chartering and regulation of insurance firms would extend uniform regulation to all areas of insurance, particularly with respect to products, producers, solvency, and market conduct protections to consumers.

Optional federal chartering and regulation should be based upon the following principles:

<u>The Federal Charter</u>

- *National Treatment* --- Insurers must have the option of obtaining a single charter that would allow them to do business in all jurisdictions.
- *Universal* --- The federal charter must accommodate all lines of insurance and must be equally available to all insurers, regardless of corporate form (stock, mutual or fraternal) or size, and must provide for the federal

chartering or licensing of insurance producers (agents and brokers) and insurance agencies.

- *Convertible* --- Insurers must have an unqualified right to convert both from a state to a federal charter and from a federal charter to a state charter, and a holding company must be permitted to control both a federally chartered and a state chartered insurer.

- *Specialized* --- The federal charter must take into account the inherent differences among different lines of insurance – life, health and property-casualty.

- *Dynamic* --- The federal charter must permit federal insurers to respond quickly to changes in the market place, consumer demands and technology.

The Federal Regulator

- *Single Regulator* --- The federal insurance regulatory authority should be a discrete bureau within the Treasury Department headed by an individual appointed by the President and confirmed by the Senate for a fixed term (on a par with the OCC and OTS).

Federal Regulation and Supervision

- *Financial/Solvency Regulation* --- A federal insurer must be subject to strong solvency regulation and supervision (e.g., capital and reserve levels, investments and accounting).

- *Regulation of Insurance and Forms* --- Federal law should establish an expeditious process for addressing policy forms, which encourages innovation and does not delay the development and marketing of new products. Federal law should rely upon competitive market forces to establish premium rates, rather than government price controls.

- *The Costs of Regulation* --- Federal insurers and producers, not taxpayers, should be responsible for the ongoing costs of federal supervision and regulation.

<u>Consumer Protections</u>

- *Market Conduct Standards* --- Federal insurers and producers must be subject to strong market conduct regulation and supervision.

- *Guarantee* --- Federal insurers and their customers must enjoy the same high level of protection in the event of an insolvency as state chartered insurers and their customers, and the existing insurance guaranty mechanisms must remain in place and accommodate the participation of federal insurers.

- *Antitrust* --- While exclusions from federal anti-trust laws provided by the McCarran-Ferguson Act should not apply to federally chartered insurers, limited safe harbors should be provided for legitimate joint activities.

- *Special Needs* --- Federal insurers should participate in state programs designed to meet the insurance needs of consumers who cannot obtain insurance. Federal insurers also should be free but not required to continue existing investment programs benefiting low and moderate income communities.

<u>Relationship to State Regulation</u>

- *Optional* --- The federal charter must be optional since the availability of a viable state insurance regulatory system is integral to the dual chartering concept.

- *Exclusive Regulation* --- A federal insurer or producer must be regulated exclusively by the federal insurance regulator in all areas defined by statute as being within the jurisdiction of the federal regulator. Conversely, state chartered insurers and producers must be regulated exclusively by state regulators.

- *Taxes* --- Federally chartered insurers must remain subject to the authority of the states to impose premium or corporate income taxes. Choice of charter should not affect the overall state and federal corporate or policyholder tax burdens of individual insurers.

- *Fair Treatment* --- States must be prohibited from discriminating against federal insurers and producers.

THE BENEFITS OF CHARTER CHOICE
THE DUAL BANKING SYSTEM AS A CASE STUDY

The United States has the strongest and most innovative banking system in the world, in large part because banks have the choice of being regulated by the state or federal government. This choice creates a healthy dynamic tension among regulators, resulting in a wider range of products and services available to consumers, lower regulatory costs, and more effective, more responsive supervision.

Dual chartering of banks has over a 130-year history in our nation. It was in 1863, after 80 years of solely state regulation, that the federal government began chartering and regulating banks. The National Bank Act signed that year did not replace the state system, as many people expected. It offered banks the choice of having a state or national charter.

Simply put, dual chartering in banking has strengthened the state charter, fostered innovation in financial products, and enhanced financial supervision.

> ***"Diversity increases the chances that innovative approaches to policy problems will emerge... A sole regulator, not subject to challenge from other agencies, might tend to become entrenched, conservative, and shortsighted."[1]***
>
> U.S. Treasury Department

Dual chartering in banking has strengthened the state charter.

The institution of the federal banking charter in the 1860s has strengthened the state charter, forcing the states to continually improve the charter. The "death" of the dual banking system has been forecasted on many different occasions, yet dual chartering continues to thrive. For example, in the 1800s, each state bank had the authority to issue its own currency in the form of bank notes. To discourage the issuance of state bank notes and to promote a uniform currency, the federal government imposed an annual 10 percent tax on such notes in 1864.

Some believed that state note taxation would end the states' experimentation in regulating banks. However, these expectations were wrong. The state bank response was to develop the checking account – still the dominant means of making payments almost 130 years after its inception.

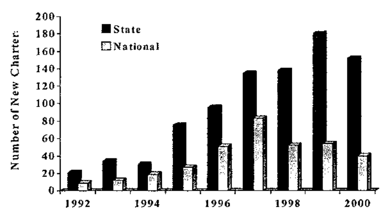
Federal Reserve Board Chairman Alan Greenspan, reflecting on this piece of banking history, noted the continued strength of the state charter:

> Any forecast at that time would quite reasonably have concluded that state banks would become historic relics. Such a projection, however, would have been quite wrong, beginning what has become an unending stream of such erroneous forecasts about the demise of state banks. Forced to find a substitute for notes, state banks

pioneered demand deposits. Within ten years after the note tax, state banks had more deposits than national banks--a lead maintained until 1943. By 1888, only 20 years after the low point, there were more state banks than national banks (approximately 3,500 vs. 3,100), a lead maintained to this day.[2]

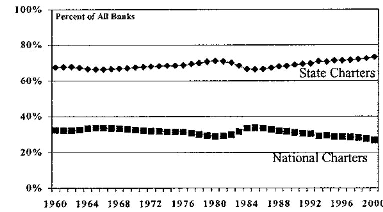
Today, over 70 percent of banks currently operate under the state charter. "I cannot overemphasize the benefits of the dual banking system," said former FDIC Chairman William Isaac. "The history of banking in this country reveals ebbs and flows in the attractiveness and dominance of the state-chartered and nationally-chartered banking systems, as the respective legislative and regulatory bodies were more or less responsive to changing conditions in the industry."[3]

New Charters of National vs. State Banks



The preference for the state charter during the 1990s has caused the state bank share of total bank assets to increase from 42 percent to over 45 percent during the decade. Despite increasing their share of overall industry assets, state-chartered banks are on average smaller than their national bank counterparts. However, this should not connote fear that state banks will be dominated by national banks. Among the 100 largest commercial banks, 45 have state charters. Ultimately, the business model employed by the commercial bank best determines the selection of charter type.

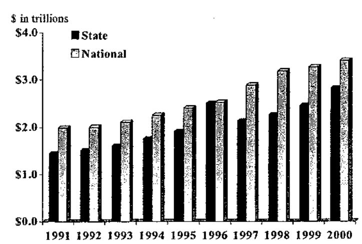
Over Seventy Percent of Banks Have State Charters



Source: Conference of State Banker Supervisors

Currently, the state charter is the charter of choice for the majority of organizers of new banks, pointing to its continued viability. In 2000, 152 new state banks began operations, compared to just 40 new national banks, continuing a trend that has persisted since 1985.

Assets of State vs. National Charters



Dual chartering fosters innovation in financial products.

For over a century, allowing charter choice has compelled state and federal regulators to continually improve the characteristics of their charters, leading to the current wide array of products and services available to consumers. Again it was William Isaac who said, "A decentralized regulatory structure can provide more opportunity and incentive for experimentation and innovation by banking firms and regulators alike."[4]

Many bank products and services that now seem commonplace evolved as a result of the regulatory competition fostered by the dual banking system. Innovations like variable rate mortgages, home equity loans, and interest-bearing transaction accounts, even the checking account, first appeared in banks under the jurisdiction of state regulators. Through initiatives of federal regulators, banks have been able to sell annuities, expand securities and mutual fund activities, and certify the security of Internet transactions – all to the benefit of bank customers.

Studies have actually argued that *not* having both federal and state charters in banking would inhibit financial services competition and its benefits for consumers. A 1986 study, for instance, concluded, "the dual banking system [has] mitigated the tendency of regulators to stifle innovation and restrict new entrants."[5]

Dual chartering fosters better financial supervision.

Providing a choice between regulators gives a broad perspective and guards against rigidity. This regulatory flexibility is important in maintaining bank competitiveness in this era of financial modernization, where banks, securities firms and insurance companies are combining operations under a single financial holding company. According to Professor Edward Kane, "... overlapping federal and state regulators looks in the short-run like wasteful duplication; but leads in the long-run to better-adapted regulatory rules."[7]

Some observers have argued that dual chartering reduces the attentiveness of regulators to safety and soundness issues. This has not been the case with banking. To the contrary, regulatory choice provides important checks and balances.

> ***"A system in which banks have choices, and in which regulations result from the give and take involving more than one agency, stands a better chance of avoiding the extremes of supervision."***[6]
>
> Federal Reserve Chairman Alan Greenspan

Permitting financial institutions a choice of charter forces regulators to update and improve examination techniques and examiner training, lest supervised institutions abandon them out of frustration. Regulators are forced to maximize efficiency. If a regulator does not control costs, institutions may shift charters to escape exorbitant supervisory fees. Moreover, regulatory authorities are encouraged to take a healthier, more positive posture on financial innovation and risk-taking when there are charter alternatives. *Regulatory choice drives down costs and increases the speed with which new products and services are developed.*

Federal Reserve Chairman Alan Greenspan agrees: "Banking supervision and regulation can only benefit from the variety of viewpoints and checks and balances of a system of more than one regulatory authority. A system in which banks have choices, and in which regulations result from the give and take involving more than one agency, stands a better chance of avoiding the extremes of supervision... A single regulator, charged with responsibility for safety and soundness, is likely to have a tendency to suppress risk taking. A system of multiple supervisors and regulators creates checks on this propensity."[8]

An equally important strength of the dual system according to Isaac, is that it "embodies a system of checks and balances between two levels of government and helps to ensure the decentralization of decision-making power. It serves as a safety valve against concentration of power in the hands of a few decision-makers, who can become imperceptive or complacent, and against the potential for abusive or simply unwise actions."[9]

This decentralization of decision-making in bank regulation has created an environment where state and federal legislative bodies and banking regulators must work together on regulatory and other policy matters that enhance financial supervision. There are many examples of state-federal cooperation. State and federal legislative bodies worked together to form the basis for first regional and then nationwide interstate banking. State-federal regulatory working groups operate across the nation on an ongoing basis to detect and deter bank fraud and share regulatory findings. Other examples include the development of consistent bank supervisory examination reports across state and federal bank regulatory agencies. State and federal agencies also accept each other's examination reports as if they were their own, and share examination report software and other technology, reducing the potential duplication of effort that could occur if there was not a high level of cooperation between them.

Conclusion: Dual chartering works.

The bottom line is that dual chartering works. It has strengthened the state charter, forcing the states to improve the charter in order to remain competitive. It also has fostered innovation in financial products, leading to the current wide array of products and services currently available to consumers. And, it has led to better financial supervision by providing a variety of viewpoints and checks and balances in our system of financial regulation.

Chairman Greenspan has argued that the absence of the dual system could actually hurt consumers, and the economy: "when there is no choice of regulatory agency, rigid policies and interfering regulatory micro-management can develop."[10] The alternative to dual chartering is thus potentially poorer services and less financial support for consumers, businesses, and ultimately, the national economy.

[1] U.S. Department of the Treasury, Modernizing the Financial System, February 1991, page XIX-6.

[2] Alan Greenspan. *Our Banking History.* Annual Meeting and Conference of the Conference of State Bank Supervisors, Nashville, TN, May 2, 1998.

[3] William M. Isaac, Director, FDIC, "Address to the 79th Annual Convention of the Conference of State Bank Supervisors," April 28, 1980.

[4] William M. Isaac, Director, FDIC, "Some Reflections on Our Dual Banking System," (Address to the Georgia Bankers Association), May 7, 1979.

[5] *E.g.*, George Benston, Robert Eisenbeis, Paul Horvitz, Edward Kane and George Kaufman, *Perspectives on Safe and Sound Banking*, 1986, page 277.

[6] Alan Greenspan, "No Single Regulator for Banks," *Wall Street Journal*, December 15, 1993.

[7] Edward Kane, The James Cleary Professor in Finance at Boston College, "Technological and Regulatory Forces in the Developing Fusion of Financial-Services Competition," *Journal of Finance* 39(3), July 1984, 759-773.

[8] Alan Greenspan, "No Single Regulator for Banks," *Wall Street Journal*, December 15, 1993. *See also,* U.S. Department of the Treasury, *Modernizing the Financial System*, February 1991, page XIX-6 (arguing that a multiplicity of regulators brings broader perspective to financial services regulation. According to the study "the existence of fewer agencies would concentrate regulatory power in the remaining ones, raising the danger of arbitrary or inflexible behavior. . . . Agency pluralism, on the other hand, may be useful, since it can bring to bear on general bank supervision the different perspectives and experiences of each regulator, and it subjects each one, where consultation and coordination are required, to the checks and balances of the others' opinion.).

[9] William M. Isaac, Director, FDIC, "Address to the 79th Annual Convention of the Conference of State Bank Supervisors," April 28, 1980.

[10] *E.g., BNA Banking Report*, March 7, 1994 (Greenspan arguing that having no alternatives in financial regulation can hurt financial consumers and the economy).

STATEMENT OF

THE FINANCIAL SERVICES COORDINATING COUNCIL

BEFORE THE

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND GOVERNMENT SPONSORED ENTERPRISES OF THE COMMITTEE ON FINANCIAL SERVICES OF THE UNITED STATES HOUSE OF REPRESENTATIVES

ON

INSURANCE REGULATION AND COMPETITION FOR THE 21ST CENTURY

June 18, 2002

The Financial Services Coordinating Council (FSCC) was formed by the four principal trade associations representing the major financial sectors of the U.S. economy to address issues of common concern at both the federal and state levels. Its members are:

- The American Bankers Association (ABA)/American Bankers Insurance Association (ABIA)—the ABA represents 90% of the assets of US commercial banks and over 200 thrift institutions. The ABIA is a separately-chartered affiliate of the ABA whose membership is composed of banks that underwrite and sell insurance as well as insurance companies that deliver product through the bank channel.

- The American Council of Life Insurers (ACLI)—The ACLI represents 435 life insurance companies, accounting for approximately 80% of the assets of all US life insurers and 83% of the assets of the insured pension business.

- The American Insurance Association (AIA) —The AIA represents 410 insurers who provide all lines of property/casualty and write more than $67 billion in premiums annually.

- The Securities Industry Association (SIA)—The SIA's 700 member security firms manage the accounts of 93 million investors directly and indirectly through corporate, thrift and pension plans, and employ approximately 750,000 individuals in the US.

Together, these organizations represent the overwhelming majority of financial services firms and provide financial services to virtually every household in America.

We appreciate the opportunity to address the Subcommittee on the topic of insurance regulation and the challenges facing both insurers and their regulators in the rapidly evolving financial services marketplace.

What the Previous Hearings Have Shown

Over the last few weeks, the Subcommittee has heard a wide range of views from insurance associations, companies, agents, regulators, legislators, and consumer advocates, all with very definite opinions on the condition of the insurance regulatory system, what it is that needs to be improved, and how that improvement can be accomplished.

Everyone, including state insurance regulators, agrees that there are significant problems with the current system in terms of lack of uniformity, administrative and compliance burdens and widespread inefficiency. Most would also agree that, if left unaddressed, these problems will ultimately result in insurers being less competitive and, more importantly, in vital insurance products and services being less innovative and less readily available. The fact is that insurance has grown from a local or regional business to one that extends from coast to coast and around the world. The current regulatory system was neither designed for nor intended to accommodate the national if not global scope of today's insurance business.

Specific Problems of the State System

The insurance regulatory environment has remained largely unchanged since 1945, when the McCarran-Ferguson Act statutorily established the principle of Congressional deference to state insurance regulation. Yet, insurers and insurance producers (agents and brokers) are coping with unprecedented and dramatic changes in the legal, political, economic, and technological environments in which they do business.

For all types of insurers, the current fifty-one regulatory system is a patchwork of individual state requirements that impose significant direct and indirect costs, including:

- higher compliance costs associated with non-uniform regulations and multiple enforcement requirements;
- complex corporate structures needed to accommodate unique regulatory regimes;
- delayed implementation of new products and pricing changes, due to prior approval requirements coupled with multi-state regulatory delays; and,
- anti-competitive regulations in many states that emphasize government price controls; create barriers to interstate commerce through entry and exit requirements; and stifle the introduction of innovative products.

Consumers would have more provider and product choices if insurers had the flexibility to offer products, and charge prices that reflect their underlying cost structures and the demands of the market.

Regulatory inefficiency results in international trade consequences as well. As more US insurers seek to do business abroad, they are encountering increasing resistance to license applications from foreign insurance regulators based solely on the burdensomeness of the balkanized insurance regulatory system in the US. The number one item on the European Union's annual list of global trade barriers is the US state insurance regulatory system. There are also reports that some countries may shortly file an action with the World Trade Organization, asserting that the US insurance regulatory system amounts to a non-tariff trade barrier. Whether or not the action is successful, it points out the increasingly international aspect of the insurance business and the patent unsuitability of the existing regulatory framework to address multi-national issues.

A Comprehensive Approach to Insurance Regulatory Modernization Is Needed

While those testifying in these hearings to date seem to understand the problems inherent in the current regulatory system, they diverge with respect to the appropriate remedy. Some have suggested that Congress should just stay on the sidelines and let the states continue unassisted in their sincere but as yet largely unproductive efforts. Others would urge piecemeal, incremental federal measures aimed at encouraging the states to become more uniform in a handful of the more egregious problem areas over a period of years—a band-aid approach that ignores the severity, scope and urgency of the situation. Still others would institute federal minimum standards, leading to mandatory federal regulation in key areas for every insurer while not providing the uniformity or relief from unnecessary administrative burden that insurers and insurance producers desperately need.

The FSCC, on the other hand, firmly believes that providing an optional federal charter for insurers, insurance agencies and insurance producers is the only way that regulatory uniformity and efficiency can be achieved, and consumer interests served, in a comprehensive and timely fashion. The optional federal charter concept is supported not only by the four FSCC member organizations and their thousands of member companies, but also by the Council of Insurance Agents and Brokers, the Financial Services Roundtable, the Financial Services Forum and a growing list of individual companies and agencies.

What an Optional Federal Charter Will Accomplish

There are four principal goals that the FSCC believes would be achieved with an optional federal charter for the insurance industry. Each goal would result in the betterment of the industry; its ability to compete with other financial services providers, and the consumers it serves.

One goal is uniformity, consistency and efficiency of regulation and supervision. A federal charter would provide insurers and producers with "one stop" regulation and supervision, rather than the patchwork of regulation and supervision by multiple jurisdictions as is the case today. This is particularly important to those organizations operating nationwide or in multiple states, and is even more compelling as product is offered over the Internet. A single point of regulation and supervision simplifies operations, eases regulatory compliance, promotes efficiency and vastly improves the ability of insurers to respond to consumer and marketplace demands in a timely and uniform fashion.

A second goal is open competition and the reduced costs and increased consumer benefits that would result. Rate regulation through government price controls and prior approval of product introduction by government agencies are anachronisms that need to be eliminated if insurers are to compete effectively with other financial services providers (banks, securities firms and mutual funds) and bring products to market in a timely fashion. The formal approval requirements in almost all states seriously jeopardize insurers' ability to get products to market in a timely fashion in all jurisdictions where they have customers or potential customers. As has been testified to repeatedly, it can take up to two years to get approvals for all markets in which an insurer desires to offer a product, and it is not at all unusual for approvals to be untimely, not uniform, or to be denied in certain markets.

Rate regulation is another anachronism to the highly competitive insurance market. For the most part, rate regulation has been nonexistent in the banking sector for almost two decades. Price controls do not protect consumers. The competitive dynamics of a free market are much better protectors of consumers. And, the consumer benefits associated with competitive rates are more than just speculative. You have heard many times throughout these hearings – both from those supportive of an optional federal charter and those opposed – that rate regulation is bad for consumers, and that fact seems to be borne out by comparing the contrasting experiences for personal lines of insurance (homeowners and auto) in Illinois (which is free from rate regulation) with those of New Jersey and Massachusetts (which are not).

Under the optional federal charter concept, the federal regulator would provide strong solvency, consumer protection, and market conduct oversight. Moreover, the federal regulator's involvement would be restricted to oversight of federally chartered insurers and producers. The federal government *would not* preempt the types of substantive insurance reparations (e.g., automobile, liability, workers' compensation) systems that states have; their tax systems; or their residual markets.

A third goal is the choice that is inherent in the enactment of a federal charter option. It is the FSCC's view, reinforced by the experience of its members with the dual banking system, that having choice between two alternative regulatory regimes – i.e., between state and federal – works to the betterment of both. The very essence of a dual system is the choice that comes from having alternatives. The experience with the dual banking system has demonstrated that choice, and the healthy tension that results from choice, has stimulated the development of new products and services for consumers, new and better supervisory techniques and more efficient supervision.

Further, as described in more detail in ABIA's testimony, the experience with the dual banking system has been just the opposite of the fears expressed by state insurance commissioners and those who oppose choice. Since the enactment of the national bank charter in 1863, the result has not been to undermine the state charter, but instead to strengthen it. Now, some 140 years later, almost 70% of banks operate under state charters, including some very large institutions like JP Morgan Chase. We strongly believe that the dual banking system can serve as an excellent prototype for insurance regulation and that the benefits that have inured to the banking industry and its customers from that system can be replicated for the insurance industry and consumers of insurance through the adoption of an optional federal charter.

The fourth and final goal is to establish a federal presence with insurance expertise in the increasingly important Washington arena. Like the banking and securities industries, insurance is a critical segment of the nation's economy, which, as noted by Chairman Oxley in his opening statement, accounts for 6 ½ % of all consumer spending. In addition to providing protection for virtually every American through life insurance and annuities, health, automobile, homeowners, personal and commercial liability and worker's compensation insurance, just to name a few, it is also the source of much of the nation's long-term capital, the largest investor in corporate debt, a major purchaser of local state and federal bonds, and a principal source of financing for hotels, shopping centers, office buildings and multiple family housing.

The time has passed when the nation can afford not to have federal expertise on an industry this complex and important to the economy. As Congress grappled with the fallout from September 11, the lack of federal sources of insurance knowledge and expertise quickly became apparent. The federal agency, which would be established under the optional federal charter concept, would eliminate this increasingly unacceptable void in federal awareness and understanding of insurance.

Opposition to the Concept of an Optional Federal Charter

Some witnesses arguing against a federal charter have described a laundry list of outcomes they fear will ensue, as if it were a radical new concept with no precedent in the annals of regulation. Compound regulation, mandatory federal charters, state revenue shortfalls, crushing social investment requirements, legislation spinning out of control with oppressive federal mandates, were all seen as strong possibilities.

As described above, however, what the optional federal charter is designed to emulate is the successful dual banking system that has served the nation extremely well since 1863. This is not an untested idea that popped into the mind of a management consultant while shaving this morning.

Moreover, the key word that optional federal charter opponents have chosen to ignore is "optional." If the legislation became burdened with unattractive federal mandates of whatever stripe, the industry would withdraw its support, and the bill would fade. This is not an effort to achieve federal regulation at any cost. As a backstop, if a bill with oppressive provisions somehow were enacted into law, no insurer would elect to take the federal option. If the bill were to be enacted but, against all odds, the states ultimately reached all of the efficiency objectives for which they are striving, fewer companies would feel the need to opt for a federal charter.

Any objective assessment of the problems described in these hearings would lead to the inescapable conclusion that it serves no practical purpose or rational public policy objective for an insurance company that is doing business nationwide (or, for that matter, a company that would like to be doing business nationwide) to be forced to comply with 51 different regulatory standards in **any** facet of its business operations, much less in **every** facet. Speed-to-market, advertising, mergers and acquisitions, price controls, market conduct, and company and agent licensing are just a few in a long list of problem areas for insurers and producers.

Even so, the concept of an optional federal charter has not received universal approval. Critics fall into one of four general categories:

- Small property/casualty companies doing business in such a limited geographical area that uniformity among state regulatory regimes is not an issue, and which, therefore, would be unlikely to consider a federal charter option even if it were available.

- A few larger property/casualty companies that prefer not to deal with changes in the system or the enhanced competition that change might bring.

- Those who are primarily concerned about regulatory or political turf.

- Self-appointed consumer advocates who oppose federal regulation, but who, until recently, could think of little good to say about state regulation.

In any event, the members of the FSCC and an increasing number of other financial services organizations believe that there is a compelling case for the optional federal charter and that prompt action is warranted. While action this year is unlikely, we hope that patience, persistence and sound reasoning will move this issue to the front burner in the next Congress.

Broad Outlines of Consensus Legislation

Three groups – the American Bankers Insurance Association, the American Council of Life Insurers, and the American Insurance Association - have each drafted its own version of an optional federal charter bill that reflect the priorities and principles of their industries and members. As noted above, these three groups along with other FSCC members have now reached agreement on a set of common principles which, if reflected in any optional federal charter legislation, would assure broad-based support for the measure from the financial services industry. A copy of these principles is appended to this statement. Taking this a step further, these three groups have nearly completed work on harmonizing and blending their separate bills into a single piece of draft legislation that all would support. The following discusses generally how this unified draft implements the common policy principles.

National Treatment – This is the cornerstone of the federal charter option. Insurers, insurance agencies and individual insurance producers would be able to get the uniformity of law, regulation, interpretation and enforcement that a federal charter affords in order to do business effectively across state lines and around the country. Under this federal charter, inconsistencies from state to state in all aspects of insurance regulation are largely eliminated.

Universal – The federal charter accommodates all lines of insurance (life/annuities, property/casualty, and health) and is available to insurers regardless of corporate form (stock, mutual, fraternal, reciprocal mutual holding company). The charter also extends to the chartering or licensing of insurance producers (agents and brokers) and insurance agencies.

Convertible – Insurers would not be prevented from selecting the type of charter (state or federal) that best meets the needs of their markets, products, and strategic plans. Insurers would be able to convert from a state to a federal charter or from a federal to a state charter, and insurance holding companies would be permitted to control both a federally chartered and a state chartered insurer. Qualification standards (state or federal) would, of course, always have to be met for any conversion.

Specialized – Today, different lines of insurance are, in many key respects, regulated quite differently by the insurance departments of the states, reflecting the unique characteristics of each of these lines. The substantive regulatory provisions of the draft bill reflect these differences in many areas. Additionally, the federal insurance regulator, both in terms of the charters it grants and the laws and regulations it administers, would have authority to differentiate among lines of business in similar fashion.

Dynamic – The ability to compete effectively in today's marketplace depends on a company being able to adapt quickly to changes in consumer demands, evolving technology, and marketplace forces. This flexibility depends to a great extent on a dynamic system of regulation able to accommodate changing circumstances. In drafting an optional federal charter, we sought an appropriate balance between those things that should appropriately be embedded in statute and those that are better left to the discretion of the regulator. We have worked hard to assure that fundamental institutional solvency and consumer protections are grounded in statute while at the same time affording the regulator ample ability to tailor aspects of the regulatory system to meet ever-changing needs and circumstances.

Single Regulator – The federal insurance regulatory authority is organized as a discrete office within the Treasury Department headed by an individual appointed by the President and confirmed by the Senate for a fixed term. Given the needs and circumstances of the insurance business, and the anticipated need to fine tune this new regulatory system, we believe this form and location of the regulator is more appropriate than an independent agency or an agency headed by a multi-member commission. The federal insurance regulator would be on a par with, but not a part of, the OCC and the OTS.

Financial/Solvency Regulation – It is essential that the federal regulator subject insurers to strong solvency regulation and supervision. The draft provides for solvency regulation based on risk-based capital standards, appropriate reserve levels, investment standards, and conservative accounting protocols. For at least an initial period of five years, the draft provides that almost all these standards would have to parallel model law standards adopted by the NAIC and found in most states today.

Regulation of Insurance Products and Forms – A significant shortcoming of the present insurance regulatory system is its inability to let companies get innovative policy forms approved and to market in a timely manner. For federally chartered insurers, the process for qualifying products for sale would be streamlined and made far more efficient. It also would reflect the unique characteristics of particular lines of insurance. For example, regarding life insurance products, individual product standards would be established by regulation and companies would make informational filings with the regulator along with a formal certification that the applicable standards have been satisfied. In the property/casualty area and for most life insurance products, competitive market forces rather than government price controls would be employed to set rates and premiums.

Cost – Other than initial startup costs (which are derived through a loan from Treasury that the regulator would repay), the ongoing costs of the new federal insurance regulator would be paid by those companies, agencies, and insurance producers opting for federal chartering, licensing and oversight. Taxpayers will not shoulder these costs.

Optional, Not Mandatory – The draft legislation makes clear that the federal charter is an optional alternative to, and not a mandatory substitute for, state oversight. Many insurers, insurance agencies, and individual insurance producers will wish to remain subject to state regulation. Others may conclude that federal regulation is more in keeping with their operations. The legislation simply affords choice. All groups that are advocating an optional federal charter are supportive of contemporaneous efforts to enhance the present state-based system of insurance regulation. A dual charter environment must have a viable, efficient state component to be successful.

Exclusive Regulation - The draft legislation provides for a federal system of regulation that is exclusive. That is, if an insurance company wishes to opt for a federal charter, the states would generally have no role with respect to matters of insurance regulatory oversight relative to that company. As drafted, all insurance companies, state and federal, would, however, under most circumstances participate in the present state-oriented insurance guarantee mechanism. Importantly, other **non-insurance** aspects of state law would continue to apply to national insurers just as they apply to national banks (e.g., employment laws, contract laws, escheat laws, and so on). Additionally, with respect to property/casualty insurance, several specific aspects of state insurance law would apply to national insurers (e.g., residual markets, pooling arrangements, and the substantive provisions state insurance reparations laws, such as state workers' compensation and personal auto insurance). All proponents of a federal charter option strongly oppose dual state/federal regulation of insurers, where a single company would simultaneously be subject to aspects of both state and federal oversight.

Taxes – The legislation explicitly provides that national insurers would remain subject to the authority of the states to impose premium or corporate income taxes. This assures that states will continue to receive the revenues they presently derive from insurers, even those that opt for a federal charter. Choice of charter would not materially affect state revenues nor would it affect the overall corporate or policyholder tax burdens of individual insurers.

Consumer Protections – The proponents of an optional federal charter recognize that legislation implementing this concept will not and should not advance unless strong consumer protections are included. The consensus draft reflects this understanding. Among the provisions of the draft legislation are the following: strong market conduct regulation and supervision; an insurance guaranty mechanism affording insurance policyholders the same high level of protection in the event of an insolvency as state chartered insurers (plus the added benefit of federal minimum standards for coverages and other key features with which all states would have to comply); the elimination for national insurers of the present federal antitrust exemption provided by the McCarran-Ferguson Act, except where they are still required to operate under state law or are participating in state authorized and regulated "advisory organization" activities; stringent investment standards mirroring the best of those found presently in state statutes; the same valuation standards that are used by the states to assure that companies have adequate reserves to pay customers' claims; more uniform and regular financial and market conduct examinations than required by states today; and, importantly, uniform consumer protection standards (e.g., sales and marketing practices of companies and agents) that would apply in all jurisdictions and not change depending on the state in which a consumer resides.

Additional Consumer Protection Consideration

Some witnesses describing themselves as consumer advocates have questioned whether, under a federal charter, consumers would be adequately protected. In this context, it is often implied that there is at present a very high level of consumer protection that might be jeopardized if companies were to switch to a federal charter.

The issue of adequate consumer protections is unquestionably an appropriate concern in any discussion of a federal charter option. Yet, we must be clear on the nature of the comparisons being drawn between what we have today and what we might have tomorrow. The fact is, we are not comparing an unknown new federal system of consumer protection with a state-based system that today receives high marks from national consumer advocates.

Over a decade ago, the Consumer Federation of America initiated a survey of state insurance departments designed to assess the adequacy of their resources to effectively regulate the insurance industry. In an August 2000 press release, Robert Hunter, Director of Insurance for CFA, stated that based on CFA's most recent survey, "It is unfortunate to see that over half of the states, representing 56% of the population score C or below. . . . Over half the states are more than 40% below the minimum needed to fully protect consumers."

We have no doubt that should Congress enact optional federal chartering legislation, it would insist on high standards of consumer protection. It is quite reasonable, then, to assume that under a system of federal insurance regulation, where uniform, high consumer protection standards apply equally all across the country, consumers would enjoy better protections than they do today. That would certainly be our goal for a federal charter.

A Broad Consensus Exists for Moving Forward with an Optional Federal Charter

More often than not, sweeping financial services legislation results in major industries being pitted against one another and little broad consensus for action. It is almost without precedent, then, that the proposal for an optional federal charter finds a far different and quite unique set of circumstances. The insurance and banking industries, historically antagonists on most issues of this nature that come before Congress, are in accord, not only on the areas of concern that must be addressed, but on the substantive approach for a legislative solution. Indeed, there is no disagreement on the utility of an optional federal insurance charter among the insurance, banking and securities industries. And while the insurance industry itself has different views on the matter, there is nonetheless extremely strong and broad support for a federal charter from the life insurance, property/casualty insurance and insurance agent segments of the business. And again, this support reflects not only agreement on the nature of the problems, but also on the details of a legislative solution.

The American Bankers Association/American Bankers Insurance Association, the American Council of Life Insurers, the American Insurance Association, the Financial Services Roundtable, the Council of Insurance Agents and Brokers, the Financial Services Forum – all support Congress moving forward with legislation providing an optional federal charter for insurers, insurance agencies, and insurance producers.

Conclusion

We urge Congress to weigh very carefully the serious regulatory problems that confront the insurance industry today and hinder its ability to effectively serve the public by providing the products and services that are so vital to this country and its economy. We also urge Congress to consider the unprecedented, broad consensus that has formed around our draft optional federal charter legislation. Please take advantage of the opportunity this unique commonality of interest provides and move ahead quickly with this extremely important legislation.

We appreciate your consideration of our views.

FSCC Financial Services Coordinating Council

Representing America's Diversified Financial Services Community

Principles for Federal Insurance Regulation

The Financial Services Coordinating Council was formed by the four principal trade associations representing the major financial sectors of the U.S. economy to address issues of common concern at both the federal and state levels.

Its members are the American Bankers Insurance Association/American Bankers Association, American Council of Life Insurers, American Insurance Association, and Securities Industry Association. These organizations represent thousands of large and small banks, insurance companies, agencies and agents, and securities firms that, taken together, provide financial services to virtually every household in America.

Given the national and international market for insurance products, the time has come to provide a federal option for the chartering and regulation of insurance firms. The lack of regulatory uniformity, coordination and responsiveness in the state-based insurance regulatory system is unnecessarily costly and burdensome and has resulted in negative competitive implications for insurance companies, insurance agencies, and their customers. The securities and banking industries have long been subject to regulation by the Federal government, which is designed to protect the interests of consumers, regardless of where a product is sold or where the consumer resides. The federal chartering and regulation of insurance firms would extend uniform regulation to all areas of insurance, particularly with respect to products, producers, solvency, and market conduct protections to consumers.

Optional federal chartering and regulation should be based upon the following principles:

<u>The Federal Charter</u>

- *National Treatment* --- Insurers must have the option of obtaining a single charter that would allow them to do business in all jurisdictions.

- *Universal* --- The federal charter must accommodate all lines of insurance and must be equally available to all insurers, regardless of corporate form (stock, mutual or fraternal) or size, and must provide for the federal

chartering or licensing of insurance producers (agents and brokers) and insurance agencies.

- *Convertible* --- Insurers must have an unqualified right to convert both from a state to a federal charter and from a federal charter to a state charter, and a holding company must be permitted to control both a federally chartered and a state chartered insurer.

- *Specialized* --- The federal charter must take into account the inherent differences among different lines of insurance – life, health and property-casualty.

- *Dynamic* --- The federal charter must permit federal insurers to respond quickly to changes in the market place, consumer demands and technology.

The Federal Regulator

- *Single Regulator* --- The federal insurance regulatory authority should be a discrete bureau within the Treasury Department headed by an individual appointed by the President and confirmed by the Senate for a fixed term (on a par with the OCC and OTS).

Federal Regulation and Supervision

- *Financial/Solvency Regulation* --- A federal insurer must be subject to strong solvency regulation and supervision (e.g., capital and reserve levels, investments and accounting).

- *Regulation of Insurance and Forms* --- Federal law should establish an expeditious process for addressing policy forms, which encourages innovation and does not delay the development and marketing of new products. Federal law should rely upon competitive market forces to establish premium rates, rather than government price controls.

- *The Costs of Regulation* --- Federal insurers and producers, not taxpayers, should be responsible for the ongoing costs of federal supervision and regulation.

Consumer Protections

- *Market Conduct Standards* --- Federal insurers and producers must be subject to strong market conduct regulation and supervision.

- *Guarantee* --- Federal insurers and their customers must enjoy the same high level of protection in the event of an insolvency as state chartered insurers and their customers, and the existing insurance guaranty mechanisms must remain in place and accommodate the participation of federal insurers.

- *Antitrust* --- While exclusions from federal anti-trust laws provided by the McCarran-Ferguson Act should not apply to federally chartered insurers, limited safe harbors should be provided for legitimate joint activities.

- *Special Needs* --- Federal insurers should participate in state programs designed to meet the insurance needs of consumers who cannot obtain insurance. Federal insurers also should be free but not required to continue existing investment programs benefiting low and moderate income communities.

Relationship to State Regulation

- *Optional* --- The federal charter must be optional since the availability of a viable state insurance regulatory system is integral to the dual chartering concept.

- *Exclusive Regulation* --- A federal insurer or producer must be regulated exclusively by the federal insurance regulator in all areas defined by statute as being within the jurisdiction of the federal regulator. Conversely, state chartered insurers and producers must be regulated exclusively by state regulators.

- *Taxes* --- Federally chartered insurers must remain subject to the authority of the states to impose premium or corporate income taxes. Choice of charter should not affect the overall state and federal corporate or policyholder tax burdens of individual insurers.

- *Fair Treatment* --- States must be prohibited from discriminating against federal insurers and producers.

TESTIMONY OF
HANS J. STERNBERG
CHAIRMAN AND CEO OF
STARMOUNT LIFE INSURANCE COMPANY

BEFORE THE
HOUSE COMMITTEE ON FINANCIAL SERVICES
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE
AND GOVERNMENT SPONSORED ENTERPRISES

RICHARD BAKER, CHAIRMAN

JUNE 18, 2002

Mr. Chairman, ranking member Kanjorski, and Members of the Subcommittee, my name is Hans Sternberg. I am chairman of Starmount Life Insurance Company. We employ 63 people, and are admitted in 18 states. I am here to offer my perspective as the owner of a small, family business. In fact, four years ago, when our premiums were under $4,000,000, I boasted we were America's "smallest" life company. This year, premiums will exceed $18,000,000. Obviously, we are still small, but growing.

I spoke to Chairman Baker about the optional federal charter to be sure small independents are not excluded by high capital or revenue minimums. Companies like mine need this legislation because the present system imposes high regulatory costs and restricts market access.

Regardless of size, all companies pay the same dollars to comply with regulation. Thus, smaller companies bear a HIGHER PERCENTAGE cost than larger ones. To GEICO (which testified here just last week), $100,000.00 is pocket change; not to companies like Starmount.

One of our divisions sells life insurance by mail. The economics of direct mail selling assume we reach all names on productive mail lists. Unfortunately, barriers to entry in many larger states make this impossible.

Conversely, we generally avoid the 12 smaller states like Delaware, North Dakota, Idaho, Montana, Wyoming, and Rhode Island, with 2,000,000 or less people, because the costs of regulation make it difficult to be profitable there.

Not only is Starmount barred from many larger markets, but citizens of both state groups lose the competitive benefits new companies bring, for example, greater product choice, lower prices, better service.

Here are other examples of what we face:

1) For several years, we bought insertion privileges in the Visa monthly bills of our local bank, which allowed us to send marketing material to the bank's Visa card holders. It was our most profitable venue. Then, the bank won a 50-state military contract. Obviously, we lost all opportunity to continue selling through the bank, because we only can sell in states that admit us. There was no way to replace that business.

2) We once developed a policy at a cost of $20,000-$25,000, which is a lot for a company our size. It was approved in all our states except two. After three years, we abandoned the program. It is not economical to promote to only part of our customer base, plus there is the constant fear of mailing to the wrong jurisdiction.

3) For years we ran a newspaper ad in several states, but one fined us $10,000.00. That state has a unique rule: if you show even one rate in an ad, you must show all rates. That would have meant 188 of them. We obviously no longer run ads in that state, but such foolishness is solely political protection for entrenched marketers, who oppose competition.

4) At one time we used brochures to sell in supermarkets. The distributor inadvertently sent the wrong state's material to some Wal-Mart stores. The insurance was approved by both states, but the minor differences caused a $7,000.00 fine. We stopped using brochures in grocery stores, so the consumer lost that option.

5) We have insurance product filed for 2.5 years, but not yet approved in every state. The excessive delay is expensive and frustrating. In the end, the consumer has less choice.

6) Our largest division uses agents to sell supplemental health benefits to companies. To take advantage of a 50-state opportunity offered to us by a national retailer, we recently partnered with a national carrier, giving half the potential sales to the partner. For us, it is better to have half the business rather than none, but the sales relinquished by us will involve millions. Over the next two years, licensing for this program will cost over $100,000.00.

The present system will always handicap Starmount's efficiency. We are forced to charge the consumer more, as well as to fall short of our sales potential, because of unnecessary and inconsistent regulations.

I urge this Committee to remember the small companies which regularly encounter these bureaucracies.

Thank you for this opportunity.

THE COUNCIL
of Insurance Agents + Brokers

Statement of

John L. Van Osdall, CPCU

Chairman, The Council of Insurance Agents + Brokers

on

Insurance Regulation and Competition for the 21st Century

Before the

House Financial Services Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises

June 18, 2002
Washington, D.C.

Statement of John L. Van Osdall, CPCU, Chairman, The Council of Insurance Agents + Brokers

Before the House Financial Services Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises

"Insurance Regulation and Competition for the 21st Century"

June 18, 2002

This statement is submitted on behalf of the members of **The Council of Insurance Agents + Brokers** ("The Council"). The Council is a national trade association founded in 1913 as the National Association of Casualty and Surety Agents. For 89 years, The Council of Insurance Agents + Brokers has provided industry leadership while representing the largest, most productive and most profitable commercial insurance agencies and brokerage firms in the U.S., and around the globe.

The Council's member firms operate in over 3,000 locations and place nearly 80% - well over $100 billion - of the U.S. commercial property/casualty premiums. In addition, The Council's members specialize in a wide range of insurance products and risk management services for business, industry, government and the public. The Council's members operate nationally and internationally and administer billions of dollars in employee benefits.

My name is John Van Osdall, and I am Senior Vice President of USI Insurance Services Corporation. I am serving as The Council's Chairman this year, as well as a member of the Board of Directors. USI Insurance Services Corporation is a growing and diversified insurance and financial services firm focused on providing fully integrated distribution of general and specialty property and casualty insurance and financial services such as employee benefits outsourcing and related consulting. With operations in 20 states, USI Insurance Services is the 6th largest insurance brokerage firm in the United States and one of the top employee benefits brokers in the U.S.

I'd like to thank you, Chairman Baker, for giving me the opportunity to testify before the Subcommittee today. The Council commends you for holding this series of hearings to examine the shortcomings in the state-based insurance regulatory system and to explore the different approaches that have been advanced to modernize that regulatory system. The Council regards itself as a pioneer within our industry on the modernization issue – though reform is a frustratingly long process. We formed our first internal committee to address the problems of interstate insurance producer licensing more than 60 years ago. Our efforts were finally rewarded with the enactment of the NARAB provisions of the Gramm-Leach-Bliley Act a few years ago – a first step on the road to insurance regulatory modernization. We thank you, Mr. Chairman, and the other members of this committee on both sides of the aisle, for your active support of the NARAB provisions during the conference on the Gramm-Leach-Bliley Act.

NARAB was a true provision of modernization in the Gramm-Leach-Bliley Act. Were it not for the tenacious support and initiative from you and Congresswoman Kelly, and the leadership of Chairman Oxley, things assuredly would not be changing for the better - particularly at their current pace. This initiative was bipartisan, and provides a very good model for a carrot-and-stick, goals-and-timetables approach that can effectively move insurance regulation forward toward goals of efficiency.

The NARAB approach to regulatory modernization is but one of the approaches that your Subcommittee has been examining in these hearings. The Council has also been studying the different routes for achieving modernization in the insurance regulatory process. To that end, The Council's Foundation for Agency Management Excellence (FAME) last year commissioned an independent study of the economic costs and benefits of these various proposals (the "FAME Study").

While it is abundantly clear to Council members that the current system of state-by-state regulation is not working, we wanted to see a full, economic analysis of the alternatives for reform. Our study, entitled "Costs & Benefits of Future Regulatory Options for the U.S. Insurance Industry," provides an in-depth examination of the pros and cons of the regulatory options available for oversight of the business of insurance. We are pleased to release this study today as a part of this hearing, and hope that it will be a useful tool as the Subcommittee continues its examination of various regulatory alternatives. A copy of this study is attached for the record, and we will refer to the study's findings as we discuss the various proposals for regulatory reform.

Even though the states have made some strides in recent years in simplification and streamlining – thanks to the enactment of the NARAB provisions of Gramm-Leach-Bliley – there are still several problem areas in the interstate licensing process that cost our members time and money unnecessarily. Insurance companies also face problems in doing business on a multi-state basis, and recent efforts by the states to streamline rate and policy form approval processes have not proven to be very successful. These continuing issues with the state-by-state regulatory process lead us to the following conclusion: relief is needed, and it is needed now. We urge the Committee to enact relief, and to do it soon.

The Council believes that it is critical to the long-term viability of the U.S. insurance industry that Congress pass legislation creating an optional federal charter for insurers. Council members know that broader reforms to the insurance regulatory system are necessary to permit the industry to operate on a more efficient basis. Such broader reforms, like an optional federal charter, are also necessary to enable the insurance industry to compete in the larger financial services industry and to be able to compete internationally. However, The Council realizes that there is a need for more immediate reforms that cannot wait for the resolution of the federal charter debate. We've taken a look at all of the proposals for regulatory reform that have been advanced in recent months, and we support them all. The Council does not believe that any of the reform proposals that have been introduced are mutually exclusive – there are opportunities for both short-term and long-term reforms that will not negate the future need for either set of reforms.

The Council has been asked to discuss the securities regulation model and its applicability to the reform of insurance regulation. We will restrict our remarks to the regulation of registered securities representatives.

A large portion of the regulation of registered securities representatives is done through the National Association of Securities Dealers (NASD), which is a self-regulatory organization established by Congress and overseen by the Securities and Exchange Commission. Registered securities representatives must still procure licenses in all states in which they wish to sell securities, but they can procure those licenses by going through one central location – the NASD's Central Registration Depository (CRD). The CRD processes registrations for the NASD and for six other securities exchanges. An individual seeking licensure with multiple organizations and/or states need only submit a uniform registration form and payment of the requisite fees. The NASD also provides a centralized authority for the enforcement of securities laws and the development of national enforcement policies. The NASD's Enforcement Division prosecutes securities violations discovered by the NASD and also receives enforcement referrals from the SEC and the various state securities regulators.

The Council believes that self-regulatory organizations (SROs) like the NASD provide a good model that could easily be modified to address the regulation of insurance producers. We would like to note at the outset that SROs are used quite commonly to regulate professional activities. For example, state bar associations are SROs that provide oversight of the legal profession. The Council's concerns with state-by-state licensing for insurance producers has never had anything to do with state regulation of insurance producers. Rather, our concerns have arisen from the myriad of idiosyncratic requirements that often have little or nothing to do with the professionalism of our members. The Council would prefer to see a single set of licensing requirements and rules of conduct that are meaningful in terms of expertise and proficiency, even if that means meeting the highest of standards that currently exist.

The Council would also like to mention that the provisions of Gramm-Leach-Bliley that provide for the formation and organization of the National Association of Registered Agents and Brokers are modeled after the NASD. It appears as though the requisite 29-state threshold has been met (under the conditions of the Gramm-Leach-Bliley Act) to avert the creation of NARAB, though at this time such a certification has not been made. However, assuming it were ever to come into being, the National Association of Registered Agents and Brokers would function in a manner similar to the NASD. It would create a national licensing clearinghouse where multistate insurance producers could obtain multiple licenses through a single point of filing. It would likely set a higher standard for licensure than currently exists in any one state, but one that is based on the professional qualifications of the individual. The National Association of Registered Agents and Brokers would also provide a centralized enforcement mechanism that would enable regulators to get bad actors out of the system sooner rather than later.

The Subcommittee should strongly consider the use of an SRO to address the continuing problems in interstate producer licensing, whether as part of an optional federal charter bill or as part of any other interim reforms that the Subcommittee would consider. The Council believes that using a supervised SRO to regulate industry activities might result in significant efficiencies and savings for consumers without diminishing the consumer protections in place today.

The Council would like to note that nothing in the federal securities laws authorizes any specific entity to act as the SRO for securities brokers; rather it provides for the creation of SROs to regulate securities broker/dealers subject to SEC oversight. The Council believes that this same approach would work well in the insurance industry, as it would permit each segment of the producer marketplace (life, health, and property/casualty) to address its own unique issues. The supervising regulator could be housed in either an independent commission or as a part of an existing agency. Council members do not feel strongly about either approach, and would likely support either one.

The Council believes that the SRO concept fits well with the optional federal charter proposals advanced by several of the groups who have already testified before this Subcommittee. We hope that you would consider adding it to any optional federal chartering legislation drafted by the Subcommittee. However, The Council also believes that the SRO concept is a good example of a goal that could be achieved as an interim step towards optional federal charter legislation. There are some other problems with the state-by-state system of insurance regulation that deserve immediate attention and that could also be stepping stones in the path towards the optional federal charter. While these problems appear to affect insurance companies more than insurance agents and brokers, we would argue that the restraints imposed by the state-by-state regulatory system on these areas affect our members just as much as the companies.

The Council's members sell and service primarily commercial property/casualty insurance. This part of the insurance industry is facing some severe challenges today due to a number of factors, including the losses incurred as a result of the terrorist attacks on September 11, 2001; increased liabilities for asbestos, toxic mold, D&O liability and medical malpractice; and years of declining investment returns and consistent negative underwriting results. Some companies have begun to exit different insurance markets as they realize that they can no longer write these coverages on a break-even basis, let alone at a profit. The end result is increased prices and declining product availability to consumers. This situation is only being exacerbated by the current state-by-state system of insurance regulation.

The FAME study mentioned earlier in our testimony notes that the current U.S. system of regulation can be characterized as a prescriptive system that generally imposes a comprehensive set of *ex ante* constraints and conditions on all aspects of regulated entities' business operations. Examples of *ex ante* requirements include things like prior approval or filing of rates and policy forms. The prescriptive approach is designed to anticipate problems and prevent the before they happen. However, this approach to regulation hinders the ability of the insurance industry to deal with changing marketplace needs and conditions in a flexible and timely manner. Consequently, it also hinders the ability of regulators to quickly address emerging problems. The Council would also argue that the prescriptive approach to regulation encourages more regulation than may be necessary in some areas, while directing precious resources from other areas that may need more regulatory attention.

It is also important to note that states wishing to do business on a national basis must deal with 51 sets of *ex ante* requirements. This tends to lead to duplicative requirements among the jurisdictions, and excessive and inefficient regulation in these areas. As the FAME study points out, the insurance industry is very concerned with the efficiency of regulation, since inefficient regulation directly affects the industry's compliance costs. However, the study also notes that while efforts aimed at improving inefficient or unneeded regulation may be easier to achieve than the total elimination of such regulation, they have the unintended result of confirming the need of the regulation in the first place.

We are then faced with this question: what should the true focus of regulation be? Are we more concerned with focusing on achieving more efficient but possibly unnecessary regulation, or should we be more focused on achieving more effective regulation that focuses on the goals of regulation – industry solvency and consumer protection?

The Council strongly believes that the primary focus of regulation should be insurance company solvency. This is, after all, the ultimate consumer protection – ensuring that companies will be around to pay claims. The Council believes that focusing on increasing the efficiency of *ex ante* requirements, like rate and policy form approval, instead of focusing on the effectiveness of industry regulation, like financial safeguards that ensure insurer solvency, is anathema to the primary objective of the insurance regulatory system.

State reform efforts in recent years have been focused on improving the efficiency of regulation to the exclusion of improving the effectiveness of regulation. Regulators are heading in the wrong direction, and The Council is concerned that dire consequences could result if regulators do not change their course. Last year, Reliance was placed into receivership and then shortly thereafter placed into liquidation. The total hit to the state guaranty funds from this insolvency has already reached $1 billion, and it's possible that number will increase due to unknown long-tail liabilities.

This is one of the largest insolvencies ever in the insurance industry, yet there has been very little discussion either in the media or among the regulatory community about Reliance's downfall. However, we have seen efforts from the states over the past two years to improve the efficiency of state-based rate and policy form filings. The Council believes that regulatory resources would be better spent in areas that improve the effectiveness of industry regulation, e.g., solvency regulation, than in areas that merely improve the efficiency of regulation that may not be necessary at all, e.g., eliminating state-based rate and policy form filings.

There is also a tension among the state insurance regulators themselves that serves as a barrier to more effective regulation. There has been a push among the states over the past several years to develop more uniform or reciprocal laws and regulations. Much of this has come in response to the enactment of the NARAB provisions of the Gramm-Leach-Bliley Act, but the states' efforts have included areas other than insurance producer licensing. Essentially, the NARAB provisions of Gramm-Leach-Bliley gave the states three years to develop a uniform or reciprocal system of nonresident insurance producer licensing. If a majority of states did not reach either uniformity or reciprocity within that time frame, then the National Association of Registered Agents and Brokers, a centralized clearinghouse for nonresident insurance producer licensing, would be formed at the federal level.

The National Association of Insurance Commissioners (NAIC) pledged not only to reach reciprocity in producer licensing, but also to reach uniformity in producer licensing as their ultimate goal. The NAIC amended its Producer Licensing Model Act (PLMA) to meet the NARAB reciprocity provisions, and worked to get the PLMA enacted in all licensing jurisdictions. As of today, forty-six states have enacted some sort of licensing reform. Most of those states have enacted the PLMA, but four states have enacted only the reciprocity portions of that Model Act. Of the states that have enacted the PLMA, there are several states that have deviated significantly from the original language of the Model Act. One state has enacted licensing reform that in no way resembles the PLMA. And the two largest states in terms of insurance premiums written, New York and California, have not enacted legislation designed to meet the NARAB reciprocity threshold at all.

The NAIC has said that it will certify by the end of June that a majority of states have met the NARAB reciprocity provisions, thereby averting the creation of NARAB. This is a commendable accomplishment, but The Council believes there is still much work to be done to reach true reciprocity and uniformity in all licensing jurisdictions, and we're not sure that the NAIC will be able to meet that goal. We finds this to be troubling, given the threat of federal intervention that was implicit in the NARAB provisions of Gramm-Leach-Bliley.

The FAME study notes that all of the regulatory modernization efforts put forward by the NAIC in the past several years have been the direct result of major external threats – either the threat of federal intervention, or the wholesale dislocation of regulated markets. It concludes that there is no guarantee that the state-based system will adopt further meaningful reforms without continued external threats to its jurisdiction, and offers the states' progress on producer licensing reform as a prime example. The Council wholeheartedly agrees with this conclusion, and urges this Subcommittee to continue to press the states to enact meaningful reforms to the insurance regulatory system.

Chairman Baker, The Council believes that you and others on your Subcommittee were absolutely on target when you talked about the need for immediate Congressional action to address the continuing problems in the state-based regulatory system. While The Council ultimately supports the enactment of an optional federal charter, we know that we can't wait for that debate to play out before getting some relief from duplicative and inefficient regulation that has little impact on the effectiveness of the insurance regulatory system. There are several targeted reforms that the Congress could address now that will benefit not only the insurance industry but also the consumers we serve. The Council believes that the areas deserving immediate attention include further reforms to the producer licensing system and speed-to-market issues that eliminate prior approval of rates and policy forms, similar to the successful model used in Illinois. The Council believes these reforms will be the easiest to achieve in the short-term.

Mr. Chairman, you have asked witnesses at the past two hearings to give you a timeline for achieving additional reforms in the insurance regulatory system, but you were not able to get a direct answer. We'd like to give you our suggestions for how to proceed with future reforms.

The Council believes that the reforms to the producer licensing system and speed-to-market reforms mentioned above need to occur as soon as possible – preferably, within the next year. These reforms will provide the most immediate relief from inefficient and duplicative regulation for the industry.

The NAIC is working on further reforms that are currently in their fledgling stages, like an interstate compact to facilitate a single point of filing and approval for life insurance products. Additionally, the NAIC is in the process of developing standards for coordination of market conduct examination. While we support the efforts of the NAIC in these areas, our experience with NARAB cautions us to be wary of their success. We would suggest that the Subcommittee continue to monitor the progress on these initiatives over the next 18 months and to be ready to act if to implement reforms in these areas if the states' efforts should fail to take hold.

The Council urges the Subcommittee, however, to continue with its work on the optional federal charter even as it develops interim reforms. The Council supports the enactment of an optional federal charter, and believes it is essential to the U.S. insurance industry's long-term survival. While there are more immediate reforms that can be made to the insurance regulatory system, those reforms in no way preclude the ultimate need for an optional federal charter. Our FAME study mentioned above has come to the same conclusion:

> Regardless of whether the states undertake significant further reforms, the inexorable trend seems to lead away from continued state regulation. If states fail to undertake significant reforms, the state system will become increasingly unsuitable to the current environment and generate tremendous pressure for wholesale change. If, on the other hand, the states undertake significant reforms and achieve a greater degree of uniformity, reciprocity and comity, those reforms will help set the stage for a further move toward federal regulation.

There is one other consideration that the Subcommittee should keep in mind as it begins its work on reforming the insurance regulatory system. The Council believes that it is critical for the Subcommittee to continue to monitor the progress made by the states in all areas of regulatory modernization. As noted above, improvements in the state insurance regulatory system have come about largely because of the leadership of this Committee, and through your continued oversight of the reform process. The Council thanks you for your attention to this critical issue, and also thanks Chairman Oxley and Rep. Kanjorski for their leadership in this area. The Council hopes that you will continue these efforts, as they benefit not only the insurance industry, but also the consumers that we serve.

In sum, Chairman Baker, The Council strongly agrees with your early statements that Congress needs to consider short-term and long-term solutions. We need state-based reforms, we need continued federal oversight and pressure to reach uniformity in state laws, and we need you to continue laying the foundation for an optional federal charter. The Council urges this Subcommittee to begin work now on those reforms that are easily obtainable in the short-term – such as further producer licensing reforms and speed-to-market – as well as the long-term reforms, like an optional federal charter, that may require further examination and debate before enactment. The Council thanks you, Mr. Chairman, for the opportunity to testify on this important issue, and stands ready to assist you in meeting these important goals.

Testimony of the National Association of Insurance Commissioners

Before the
Subcommittee on Capital Markets, Insurance, and
Government Sponsored Enterprises

Committee on Financial Services
United States House of Representatives

Regarding:
Insurance Regulation and Competition for the 21st Century

June 18, 2002

Terri M. Vaughan
Commissioner of Insurance
Iowa

Testimony of Terri Vaughan, President
National Association of Insurance Commissioners

Introduction

My name is Terri Vaughan. I am the Commissioner of Insurance for the State of Iowa, and this year I am serving as President of the National Association of Insurance Commissioners (NAIC). I am pleased to be here on behalf of the NAIC and its members to provide the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises with an update of our efforts to modernize state insurance supervision to meet the true demands of the 21st Century.

Today, I would like to make three basic points –

- First, the sole reason for government regulation of insurers and agents is to protect American consumers. Effective consumer protection that focuses on local needs is the hallmark of state insurance regulation. We understand local and regional markets and the needs of consumers in these markets. We recognize that consumer protection is the purpose of our jobs. Meaningful evaluation of the existing state regulatory system or any federal alternative must begin with a hard look at its impact on current protections that the public expects.

- Second, NAIC and the states are well underway in our efforts to modernize state regulation where improvements are needed, while preserving the benefits of local consumer protection that is the real strength of state insurance regulation. In some areas, our goal is to achieve national uniformity because it makes sense for both consumers and insurers. In areas where different standards among states are justified because they reflect regional needs, we are harmonizing state regulatory procedures to ease compliance by insurers and agents doing business in those markets.

- Third, we believe that all federal legislation dealing with insurance regulation carries the risks of undermining state consumer protections due to unintended or unnecessary preemption of state laws and regulations. Implementing proposals to create an optional federal charter and establish a related regulatory apparatus will have a serious negative impact on the state regulatory system, including our efforts to make improvements in areas sought by proponents of a federal charter.

Why Are Insurance Companies and Agents Regulated?

As the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises evaluates state insurance regulation, the NAIC and its members hope you will start by asking the fundamental question: "Why are insurance companies and agents regulated in the United States?" We believe the answers to other questions being raised about the success of the state system will be found by first asking the right question regarding why we regulate insurance products and providers.

Government regulation of insurance companies and agents began in the states well over 100 years ago for one overriding reason – to protect consumers. Our most important consumer protection is to assure that insurers remain solvent so they can meet their obligations to pay claims, as most recently evidenced in the aftermath of September 11th. Beyond that, states supervise insurance sales and marketing practices, as well as policy terms and conditions, to ensure that consumers are treated fairly when they purchase insurance products and file claims. Unlike most products, the purchaser of an insurance policy will not be able to fully determine the value of the product purchased until after a claim is presented—when it is too late to decide that a different insurer or a different product might make a better choice.

The Subcommittee's theme for these hearings is "Insurance Regulation and Competition for the 21st Century". While commercial competition is certainly a significant aspect of the insurance markets in the United States, it has not been the primary purpose of government regulation, nor is it the most important factor in judging how well the state system – or any potential federal supervision system – works. Vigorous competition to attract profitable business is widespread in the insurance industry for most insurance lines. The purpose of government supervision is to make sure the critical personal interests of consumers are not lost in the arena of commercial competition.

Once the consumer protection responsibilities of government insurance regulators are satisfied, it is fair to ask how the system of regulation can be made most compatible with the demands of commercial competition without sacrificing the needs of consumers. The NAIC and state regulators have given much attention over the years to minimizing the impact of our essential supervision responsibilities on commercial competition. We continue to give this matter our highest attention.

Protecting Consumers is the First Priority of State Insurance Regulation

Paying for insurance products is one of the largest consumer expenditures of any kind for most Americans. Figures compiled by the NAIC show that an average family can easily spend a combined total of $4,500 each year for auto, home, life, and health insurance coverage. This substantial expenditure – often required by law or business practice – is typically much higher for families with several members, more than one car, or additional property to insure. Consumers clearly have an enormous financial and emotional stake in making sure that the promises made by insurance providers are kept.

Protecting insurance consumers in a world of hybrid institutions and products must start with a basic understanding that insurance is a different business than banking and securities. Insurance is a commercial product based upon subjective business decisions such as these: Will an insurance policy be offered to a consumer? At what price? What are the policy terms and conditions? Is a claim filed by a policyholder valid? If so, how much should the customer be paid under the policy terms? All of these subjective business decisions add up to one big certainty – insurance products can generate a high level of consumer backlash and customer dissatisfaction that requires a high level of regulatory resources and responsiveness.

As regulators of insurance, state governments are responsible for making sure the expectations of American consumers – including those who are elderly or low-income – are met regarding financial safety and fair treatment by insurance providers. State insurance commissioners are the public officials who are appointed or elected to perform this consumer protection function. Nationwide in 2000, we employed 12,500 regulatory personnel and spent $880 million to be the watchful eyes and helping hands on consumer insurance problems. The states also maintain a system of financial guarantee funds that cover personal losses of consumers in the event of an insurer insolvency.

It is important for Congress to note that the entire state insurance system is authorized, funded, and operated at no cost to the federal government.

States Have a Strong Record of Successful Consumer Protection

There have been charges from industry that the state regulatory system is inefficient and burdensome, and that a single federal regulator would be better. As government officials responsible for operating the state system, we understand that any and all government regulation, including insurance regulation, can be inconvenient and occasionally frustrating to commercial entities who wish to do business on their own terms. We are constantly improving our standards and procedures to meet those concerns.

However, the NAIC and its members do not believe the consumers we serve each day think we are inefficient or burdensome when compared to the agencies and departments of the federal government. During 2000, we handled approximately 4.5 million consumer inquiries and complaints regarding the content of their policies and their treatment by insurance companies and agents. Many of those calls led to a successful resolution of the problem at little or no cost to the consumer.

The September 11, 2001 terrorist attacks on America were a horrible and tragic event that exposed serious weaknesses in certain government operations in this country. Yet the state insurance regulatory system was proven to be sound, even when hit with a sudden catastrophe that ultimately will be the most expensive in history, estimated to cost $35 to $40 billion. From the earliest days until the present, state insurance departments and the NAIC have closely monitored the solvency of affected insurers and the payment of claims to policyholders. If our system operates smoothly under the most horrific and unexpected conditions, we question why anyone would want to supplant it.

At the Subcommittee's June 4th hearing, one of the industry witnesses testified that a recent Roper opinion poll concluded the public rates state governments as being better than the federal government at consumer protection. This statement does not surprise us. State regulators know from years of firsthand experience that when consumers need help with insurance sales or claims problems, they naturally look to their local state agency charged with supervising insurance to get assistance. We are accessible through a local call or visit, and every state has trained staff and education programs to assist consumers promptly.

State Regulatory Modernization Update

While recognizing the inherent strength of our system when it comes to protecting consumers, we also agree that there is a need to improve the efficiency of the system. In March 2000, the Nation's insurance commissioners committed to modernizing the state system in specific areas by endorsing a new action plan entitled *Statement of Intent – The Future of Insurance Regulation*. Working in their individual states and collectively through the NAIC, the commissioners have made tremendous progress. Looking ahead, these efforts will continue as the states work to deliver on the goals and objectives set forth in the *Statement of Intent*: Creating an efficient, market-oriented regulatory system for the business of insurance.

The NAIC and its members are proud of what's been accomplished so far, but there is still much work to be done. Consumer needs and the realities of the new financial services marketplace make smart and efficient regulation all the more critical.

Implementing the initiatives in the *Statement of Intent* will move state insurance regulation beyond the specific requirements of the Gramm-Leach-Bliley Act by promoting uniformity and greater efficiency for agent and company licensing, while speeding up the process for bringing new products to market.

A summary giving the current status of state modernization initiatives can be found at the end of this statement as "Attachment A".

Achieving State Uniformity for Life Insurance Products

In responding to the demands of insurance consumers in each state, the NAIC generally agrees with the comment by a previous industry witness that "state uniformity is not the holy grail." However, where appropriate, NAIC and the states are working to achieve full regulatory uniformity to benefit both consumers and insurance providers. Marketing life insurance is an area where we agree with industry that national uniformity is needed to enable life insurers to market products nationally. In fact, aside from producer licensing, this is one of the few areas that has generated a true national consensus for reform among all segments of industry, consumers, and regulators.

To accomplish uniform supervision of life insurance products within the state system, the NAIC is currently working with state regulators and legislators to draft an interstate compact that gets the job done, while preserving necessary and effective state consumer protections.

These are the reasons we believe an interstate compact is the correct mechanism to achieve state uniformity:

- Many products sold by life insurers have evolved to become primarily investment products. Consequently, life insurers increasingly face direct competition from products offered by depository institutions and securities firms. Because these competitors are able to sell one product nationally, often without any prior regulatory review, they are able to bring new products to market more quickly and without the added expense of meeting different requirements in different states.

- Recognizing that consumers may hold life insurance policies for many years, the increasing mobility in society means states have many consumers who have purchased policies in other states. This reality raises questions about the logic of different standards in different states.

- State insurance regulators have worked diligently for more than two years to identify the issues in this area, and come up with possible solutions to reflect the new market realities. The CARFRA pilot project is currently underway with 22 states now participating. One issue that is proving difficult to overcome is the elimination of state regulatory differences.

- State insurance regulators now believe an interstate compact is a way to develop a more efficient review process for life insurance and annuity products – one that will help insurers better compete in the marketplace while maintaining a high level of protection for insurance consumers.

- The goal of the compact is to establish a single point of filing where life insurers would file their products for approval and thereafter, assuming the product satisfies appropriate product standards created jointly by the compacting states, be able to sell those products in multiple states without the need for making separate filings in each state.

    First, it allows the states to jointly develop uniform standards for certain annuity and life insurance products having very similar characteristics nationally.

    Second, it allows the states to conduct product reviews in a more efficient manner, i.e., "Fewer sets of eyes required to review a product filing."

    Third, it will allow states to continue providing a high degree of protection to insurance consumers without increasing the cost of providing quality regulatory oversight of the marketplace.

    Finally, it will allow life insurers to develop their products and get them to the marketplace in a timely manner and with cost savings (which benefits the insurance-buying public).

- Key points: (1) The states will continue to regulate product approvals for annuities and life insurance products through the compact (as opposed to federal preemption). (2) Each state in the compact helps govern the activities of the compact. (3) We do not anticipate that states will lose revenues generated through product filings. (4) States will be able to withdraw from the compact through legislative action.

- Timeline: Over the next few months, state insurance regulators will continue to work with their legislators, as well as consumer and life insurance industry representatives to develop model compact legislation. The goal is to get the model legislative language finalized by September and be in position to have compact legislation introduced in state legislatures during the 2003 session.

Subcommittee Questions to NAIC

In its letter of invitation, the Subcommittee asked that NAIC address the following specific questions in its testimony today –

What is the current status of state agent licensing reforms?

In the area of producer licensing reform, states remain on target to exceed the goals set forth in the NARAB section of the Gramm-Leach-Bliley Act (GLBA). GLBA requires that 29 states enact laws providing for producer licensing reciprocity. To date, 46 states have enacted legislation designed to satisfy GLBA, and legislation is being considered by four additional jurisdictions. While the NAIC believes these numbers represent a significant success in the area of producer licensing reform, the NAIC continues to work toward the goal of uniformity in state producer licensing.

After the passage of GLBA, the NAIC formed the NARAB Working Group to oversee the process of producer licensing reform. In the course of its work, the NARAB Working Group identified a number of issues related to producer licensing generally, and the achievement of reciprocity specifically, for which GLBA provides no clear guidance. Consistent with the responsibility GLBA gives to the NAIC to make the determination as to whether the reciprocity objectives have been met, the NARAB Working Group developed a framework through which it analyzed and resolved important issues crucial to meeting reciprocity. This framework provides the legal lens through which the NARAB Working Group is analyzing whether states in fact meet the requirements for reciprocity as set forth in GLBA.

For the NAIC to certify that 29 states meet reciprocity, we believe GLBA requires our best assessment of where the state licensing laws and procedures will stand on November 12, 2002. Using its own reciprocity framework as well as the NARAB provisions of GLBA, the NARAB Working Group developed a Reciprocity Checklist as a tool for undertaking this reciprocity verification process.

The Checklist asks specific questions relating to the achievement of reciprocity. States were asked to undertake a thorough review of their laws, complete the Checklist, and certify that their laws meet the criteria for reciprocity. Once completed and returned to the NAIC, the Checklists are posted on the NAIC's website (www.naic.org) for public review. Interested parties were notified of the availability of the Checklists, as well as the opportunity to provide written comments within 30 days of each Checklist's posting. These comments have also been posted to the website. The NARAB Working Group expects to recommend to the NAIC membership by our September national meeting that the states collectively have exceeded GLBA's reciprocity target. We will notify Congress when the NAIC as a whole adopts the NARAB Working Group's confirmation of state success in meeting the requirements of GLBA.

Although the NAIC's efforts in achieving producer licensing reciprocity are almost complete, the NARAB Working Group is continuing to work on refining uniformity issues in the following producer licensing areas: (a) licensing qualifications, (b) pre-licensing education training, (c) producer licensing testing, (d) integrity and personal background checks, (e) application for licensure structure, and (f) continuing education requirements.

To date how many jurisdictions have passed NARAB-compliant legislation? What percent of total premium do these jurisdictions represent?

To date, 46 states have enacted new producer licensing legislation. The premium volume for these 46 states is approximately $679 billion, which represents 76 percent of total nationwide premiums of $892 billion. In addition, producer licensing legislation is now being considered in four additional jurisdictions. As explained above, the NAIC process of determining compliance with NARAB is still ongoing.

What are the NAIC's goals for improving the insurance product approval process in both the life and property/casualty industries?

The NAIC created the Improvements to State Based Systems Working Group to review product approval modernization efforts and expedite state adoption of them. The Working Groups has five subgroups that focus on specific areas of reform – the Review Standards Checklists Subgroup, the Property/Casualty Product Uniformity Subgroup, the SERFF Enhancements Subgroup, the Life, Accident and Health Product Coding Subgroup, and the Filing Submission Uniformity/Metrics Subgroup. They are also assisted by the Statistical Information Task Force.

During 2001 and 2002, the NAIC developed common filing transmittal documents for both property/casualty and life/health insurers. Also, a matrix was developed to implement a common naming process for all insurance products. Phase I uniform filing metrics have been developed to evaluate speed to market goals and allow for measurement of the time it takes for insurance departments to react to filings and insurers to respond to inquires from insurance departments. This should allow us to pinpoint whether the problem is with slow response from states or delay in response by insurers. Phase II will include quality measures to evaluate the effectiveness of filing review. Full details and a map of participating states can be found on the NAIC's website under "RATES & FORMS." The next phase of that project is to identify differences in state requirements, and to establish a searchable tool on the web that will allow a filer to know exactly what is required for every state and every line of business. Many states have implemented filing review standards checklists. These can also be found on the NAIC web site.

The NAIC has also implemented SERFF (System for Electronic Rate and Form Filings). All 50 states and the District of Columbia have SERFF licenses, and 49 of the jurisdictions are accepting electronic SERFF filings checklists to facilitate company compliance with filing requirements. SERFF has been vastly improved. The average turnaround time for a filing submitted through SERFF is 16 days from start to finish, offering insurers that use the system true speed to market for product review.

Almost 500 companies are now filing with the states using SERFF. One company told us that with SERFF its cost per filing has dropped from $38 down to less than $10 per filing, with added savings because the regulatory review is done more quickly. With SERFF, we have a readymade opportunity to streamline and generate savings to companies and presumably their customers. We wonder why more companies aren't taking advantage of SERFF, since many have testified to the NAIC about the costs and times savings.

What steps are being taken by the NAIC to reach these goals, including a discussion of the interstate compact mechanism currently being considered by the NAIC to improve life insurance product review?

The NAIC is currently working on a plan to develop an interstate compact to: (a) develop uniform standards for annuities, life insurance, disability income insurance and long-term care product lines; (b) receive and review product filings from insurers; and (c) approve those product filings that satisfy applicable uniform standards.

As currently envisioned, the compact entity will serve as a single point of filing for those insurers seeking to introduce produced on a national scale Once the compact is in place with a sufficient number of states as members, products approved by the compact entity may be sold or issued in those compact states where the insurer is licensed to do business. Other important points to remember about the proposal: it allows the development of uniform standards that will protect consumers while at the same time affording insurers a more efficient process to get their products to the market place. This will benefit consumers, who will have access to more competitive products, as well as insurers, who will be able to remain competitive with banks and securities firms.

What is the NAIC's position on the need for market-based regulatory reform of commercial and personal forms and rates?

The NAIC has developed a streamlined model law to implement market based reforms for commercial lines. We long ago concluded that competition could be an effective regulator of property/casualty insurance rates. Recent consideration of commercial lines rate regulation led to the conclusion that commercial insurance consumers will generally be better served by less restrictive regulatory interventions and a greater reliance on competition. This led to a recommendation supporting a use and file system for commercial lines rates.

The NAIC has two other alternative model laws for property and casualty rates. One is a prior approval law, and the second is a file and use law that relies on competition as the principle regulatory of rate level. There is also an NAIC group that is evaluating the benefits of market-based models for personal lines markets. However, this group has not completed its review process and has not yet made any recommendations regarding personal lines.

Federal Legislation Must Not Undermine State Modernization Efforts

The NAIC and its members believe Congress must be very careful in considering potential federal legislation to achieve modernization of insurance regulation in the United States. Even well-intended and seemingly benign federal legislation can have a substantial adverse impact on state laws and regulations that protect insurance consumers.

Because federal law preempts conflicting state laws under the United States Constitution, ill-considered or poorly written federal laws can easily undermine or negate important state legal protections for American consumers.

When Congress passed the Gramm-Leach-Bliley Act (GLBA) in 1999, it acknowledged once again that states should regulate the business of insurance in the United States, as set forth originally in the McCarran-Ferguson Act. There was a careful statutory balancing of regulatory responsibilities among federal banking and securities agencies and state insurance departments, with the result that federal agencies would not be involved in making regulatory determinations about insurance matters. The only exception was in a few narrow areas where the Office of the Comptroller of the Currency (OCC) had previously determined that certain insurance-related activities were incidental to banking under federal law.

Even though Congress tried very hard in GLBA to craft language that would not preempt state laws unnecessarily, there have already been disagreements about the extent to which federally-chartered banks may conduct insurance-related activities without complying with state laws. Under GLBA, no state law may "prevent or significantly interfere" with the ability of a federally-chartered bank to conduct insurance-related business permitted by GLBA. Federally-chartered banks, with support from OCC, are aggressively asserting their perceived rights under GLBA to conduct insurance-related business unhindered by state laws. The limited entry of federally-chartered banks into insurance has thus become a source of uncertainty and dispute, despite the best efforts of Congress to avoid this very result.

We fully expect that creating a federal charter for insurers, along with its federal regulatory structure, will cause far greater problems for states and insurance regulation in general than those resulting from the GLBA provisions dealing with banks. Federally-chartered insurers would certainly insist that state laws involving solvency and market conduct cannot "prevent or significantly interfere" with their federally-granted powers to conduct insurance business anywhere in the United States. A federal insurance charter with its associated laws and regulations must necessarily parallel every aspect of existing state laws and regulations, meaning that potential conflicts between state and federal laws will likely occur across the board. The result would be years of market and regulatory confusion that will benefit the legal community rather than insurance providers and consumers.

The Financial Services Committee carefully noted the role of states as insurance regulators in passing HR 1408 (Financial Services Antifraud Network Act) and HR 3210 (Terrorism Risk Protection Act). One of the great strengths of state insurance regulation is that it is rooted in other state laws that largely apply when insurable events occur. The NAIC requests that you avoid undercutting state authority in considering any federal legislation that would set national standards for states or create a federal insurance charter. Federal laws that appear simple on their face can have devastating consequences for state insurance departments trying to protect the public.

The Impact of Federal Chartering on State Regulation Will Not Be Optional

Some witnesses have told this Subcommittee that a federal charter merely adds an optional choice to the insurance regulatory system in the United States, and that it would not seriously affect the existing state system. In my home state of Iowa, folks might refer to such claims as "hogwash." A federal charter may be optional for an insurer choosing it, but the negative impact of federally-regulated insurers will not be optional for state-chartered insurers, consumers, state government, and local taxpayers who are affected, even though they have no say in the choice of a federal charter.

Let us be clear about the impact of a federal insurance regulator upon state regulation and our ability to protect consumers – <u>the federal government is not an equal regulatory partner because it can preempt state laws and regulations</u>. This simple fact contradicts the very foundation of insurance in the United States, because insurance products are uniquely intertwined and dependent upon state law for everything from underwriting standards to pricing to claims procedures to legal resolution of disputes. There is no logical or practical way to divorce insurance regulation from the state laws that give rise to insurance products in the first place.

Despite our different sizes, geography, and market needs, states work together through the NAIC as legal equals under the present system. We find solutions as a peer group through give-and-take and mutual respect, knowing that no single state can force its own way over the objections of other states. We believe such participatory democracy and local decision-making based on the realities of local markets and consumers is a major strength of our system for regulating insurers and agents.

A federal insurance regulator would not be just another member of NAIC, it would instead be a super-agency with power to intervene and overrule every state and territory under United States jurisdiction. The local needs and wants of citizens protected under state laws would be subjugated to the national agenda of insurers and regulators located "Inside-the-Beltway."

Ultimately, a federal charter and its regulatory system would result in two separate insurance systems operating in each state. The first would be the current department of insurance established and operated under state law and government supervision. This system will continue responding directly to state voters and taxpayers, including the statewide election of the insurance commissioner in several states.

The second system would be a new federal regulator with zero experience or grounding in the local state laws that control the content of insurance policies, claims procedures, contracts, and legal rights of citizens in tort litigation. Nonetheless, this new federal regulator would undoubtedly have the power to preempt state laws and authorities that disagree with the laws that govern policyholders and claimants of state-chartered insurers. At the very least, this situation will lead to confusion. At worst, it will lead to two levels of consumer protection, based upon whether an insurer is chartered by federal or state government.

Granting a government charter for an insurer means taking full responsibility for the consequences, including the costs of insolvencies and the complaints of consumers. The states have fully accepted these responsibilities by covering all facets of insurance licensing, solvency monitoring, market conduct, and handling of insolvent insurers. The NAIC does not believe Congress will have the luxury of granting insurer business licenses without also being drawn into the full range of responsibilities that go hand-in-hand with a government charter to underwrite and sell insurance. Furthermore, we doubt that states will accept responsibility for the mistakes or inaction of a federal regulator by including federal insurers under state guarantee funds and other consumer protection schemes.

Conclusion

The system of state insurance regulation in the United States has worked well for 125 years. State regulators understand that protecting America's insurance consumers is our first responsibility. We also understand that commercial insurance markets have changed, and that modernization of state insurance standards and procedures is needed to ease regulatory compliance for insurers and agents.

We ask Congress and insurance industry participants to work with us to implement the NAIC's modernization initiatives through the state legislative system. That is the only practical way to achieve necessary changes quickly in a manner that preserves state consumer protections expected by the public. The state process may take more effort than having an insurance czar in Washington, but it rewards the citizens and consumers in each state by giving them control over important aspects of insurance and claims procedures that affect their financial security in the communities where they live.

The NAIC and its members have cooperated fully over the years with important inquiries by Congress into the adequacy of the state regulatory system. We believe these inquiries have demonstrated clearly that local and regional state regulation of insurance is the best way to meet the demands of consumers for this unique financial product. We will continue to work with Congress and within state government to improve the national efficiency of state insurance regulation while preserving its longstanding dedication to protecting American consumers.

ATTACHMENT A

NAIC

The Statement of Intent — Delivering on a Promise

In March 2000, the nation's insurance commissioners endorsed the *Statement of Intent – The Future of Insurance Regulation*. Working in their individual states and collectively through the NAIC, the commissioners have made tremendous progress. Looking ahead, these efforts will continue as the states work to deliver on the *Statement of Intent* promise: The creation of an efficient, market-oriented regulation of the business of insurance.

The NAIC members are proud of what's been accomplished. But there's still work to be done. Consumer needs and the realities of the new financial services marketplace make regulation all the more critical. That's why these *Statement of Intent* initiatives — many of which are now being implemented — are needed. They will move state insurance regulation beyond the specific requirements of the Gramm-Leach-Bliley Act, by promoting uniformity and greater efficiency for agent and company licensing, while speeding up the process for bringing new products to market.

As an organization of state officials responsible for protecting the public, the NAIC is committed to protecting consumers, keeping insurers and producers accountable, and maintaining a sound and non-discriminatory insurance regulatory system in the United States. And, NAIC members are prepared to prove that functional insurance regulation, at the state level, is the best insurance regulatory system.

Responding to the NARAB Requirement

- As of June 5, 2002, 46 states have passed the Producer Licensing Model Act (PLMA) or other licensing laws with the intent of satisfying the reciprocity licensing mandates of GLBA. Four more legislatures are considering PLMA in 2002.
- Ten states have begun to process non-resident applications electronically through the National Insurance Producer Registry (NIPR) gateway. Since Jan. 1, 2002, more than 1,500 license applications have been processed.

- The Uniform Non-Resident Application is now accepted in 46 states, and in some states is accepted for surplus lines and limited line licensing.

Speed to Market Initiatives

- SERFF and Other State-based Systems Reforms
    - All 50 states and the District of Columbia are licensed to use the System for Electronic Rate and Form Filing (SERFF), the first electronic system for product filings by insurers.
    - Forty-four jurisdictions have implemented rate and form filing checklists and review standards, which are linked from the NAIC Web site.
    - 474 companies are licensed to use SERFF, 74 of which joined the program in the fourth quarter of 2001.
    - SERFF Filings are turned around in sixteen days on average.
- CARFRA
    - The Coordinated Advertising, Rate and Form Review Authority (CARFRA) provides a single point of filing and review, along with national standards for life and health insurance products. Twelve new states were added to the CARFRA program in June, bringing total participation to 22 states. Two new products — Individual Flexible Premium Universal Life and Individual Variable Annuity — are being considered.
- Interstate Compact
    - NAIC members are working to create an interstate compact for single point of filing that will develop uniform standards, and will have the flexibility to include life insurance, annuities, disability income and long-term care products.
    - The interstate compact will set uniform standards, receive product filings, and give regulatory approval.
- Five New Subgroups
    - The Improvements to State-Based Systems Working Group has appointed four new subgroups: the Review Standards Checklist Subgroup, the Property and Casualty Product Uniformity Subgroup, the SERFF Enhancements Subgroup, the Life, Accident and Health Product Coding Subgroup, and the Filing Submission Uniformity/Metrics Subgroup.

Uniformity in Company Licensing and Corporate Governance

- The Uniform Certificate of Authority Application (UCAA), a company licensing system that expedites the review process of a new state license, is in its implementation phase. With some exceptions, the information underlying the application is uniform throughout the United States. All jurisdictions have agreed to accept licensing applications according to UCAA system forms and guidelines.
- In addition to addressing regulatory requirements associated with a company licensing process, the "national treatment" initiative is focused on bringing greater consistency to corporate governance requirements and procedures for amending a certificate of authority.
- An NAIC automated system for facilitating the UCAA and related filings was put into production in late 2001.
- Later this year, the National Treatment & Coordination Working Group will conduct a corporate reorganization pilot project. This project will focus on the regulatory requirements involved after an approved merger or acquisition of multiple insurers. The project is expected to cover such areas as product approval, re-appointment of agents, changes in articles/by-laws and company name, etc.
- Efforts are currently underway to have 35 states waive paper filings of annual and quarterly financial statements from foreign companies. The states that waive paper filings will rely on electronic data filed with the NAIC to serve their regulatory needs. These states will benefit significantly by reducing the costs involved in receiving, tracking and storing paper filings.

Coordination on Insurance Holding Company Matters

- NAIC members drafted an extensive and detailed guide for state financial regulators to use in analyzing the overall operations of an insurer that is part of a larger business group. The paper, titled "Framework for Insurance Holding Company Analysis," provides guidance on understanding a holding company structure with insurers, as well as a coordinated approach to the review of holding company transactions that impact insurance subsidiaries domiciled in multiple jurisdictions.
- An NAIC database has been developed to facilitate information sharing on acquisition and merger filings, otherwise known as a Form A filing. This database, in conjunction with other related work, will help ensure effective communication among states on merger and acquisition filings, as well as provide regulatory efficiencies to the insurance industry.
- Focused efforts are presently underway to institute a "lead state" framework within the state regulatory system. Once implemented, on-site examinations,

financial analysis and other regulatory review processes are expected to function in a more coordinated and efficient manner.

Implementing Privacy Protections

- Forty-nine states and the District of Columbia now have privacy protections in place that meet GLBA standards, with discussions about uniform interpretation now underway.
- NAIC members adopted the Standards for Safeguarding Customer Information Model Regulation in April. The new model regulation establishes standards for insurers to meet the confidentiality and security requirements of section 501 of GLBA. New York has promulgated a regulation based on the model, and other states are expected to follow suit.
- The Privacy Notice Content Subgroup was formed to draft sample language for insurers to use so privacy notices are understandable to consumers, while retaining operational uniformity and compliance with the requirements of the NAIC model privacy regulation that are critical to industry. The subgroup is actively working on this project.

Consumer Protections

- In December 2001, members of the NAIC successfully launched an interactive Web tool, the Consumer Information Source (CIS), specifically created for consumer research of company complaint and financial data.
- CIS allows consumers to locate basic information about a specific insurance company, including amount of premiums written, assets, liabilities and licensing information. The site also allows consumers to file consumer complaints and review statistical information on previously resolved complaints against a company. During 2002, the Consumer Protection Working Group hopes to refine and enhance the CIS program.
- The NAIC's Consumer Protection and Antifraud Division is working with the NAIC's Information Systems Division to set up a pilot program for producer fingerprinting.

Coordinating with Federal Regulators

- Recognizing the need for improved cooperation and communication with federal financial services regulators, particularly in the wake of enactment of GLBA and the convergence of the financial services industries, the NAIC continues to push for strong working relationships between state insurance regulators and their federal financial services counterparts.

- Over the last several years, the NAIC has participated in a series of high-level meetings involving NAIC officers and members with the top federal regulators from the OCC, OTS, Federal Deposit Insurance Corporation (FDIC) and Federal Reserve. Ongoing regulator-to-regulator consultations have been held to discuss examination procedures and enhance the development of needed expertise and exchange of information with respect to regulatory trends in the changing financial services marketplace.
- Efforts are currently underway to develop stronger working relationships with the Securities and Exchange Commission (SEC). Through the NAIC, the SEC is working with several states on privacy enforcement efforts, and the NAIC hopes to expand these coordination efforts to new areas this year. The NAIC is scheduled to meet with SEC representatives in June to discuss issues of common concern.
- The development of regulatory cooperation agreements with federal agencies has been a high priority for NAIC members. These model agreements provide for the sharing of relevant regulatory information, including information about examinations, enforcement and consumer protections. They also include provisions to ensure the protection of confidential information.
- As of May 2002, 45 states plus the District of Columbia have signed regulatory cooperation agreements with the OTS; 33 states plus the District of Columbia have signed agreements with the OCC; 40 states plus the District of Columbia have agreements with the FDIC; and 25 states plus the District of Columbia have agreements with the Federal Reserve.

Market Regulation Reforms

- The NAIC is focusing on the following four areas to build a more effective, nationally coordinated market regulation system: (1) market analysis, (2) uniform examination procedures, (3) market conduct examination resource guidelines and (4) interstate collaboration.
- Market analysis will provide important tools for monitoring the broader marketplace so that (1) market regulatory problems can be identified, (2) states may better prioritize and coordinate the various market regulation functions and (3) states may establish an integrated system of proportional responses to market problems. The goal for 2002 is to develop a "Market Analysis How-To Guide" for states and a Market Conduct Annual Statement to identify priority issues and collect data on these issues.
- The following four areas have been identified as the most important areas for exam uniformity: (1) exam scheduling, (2) pre-exam planning, (3) exam procedures and (4) exam reports. The goal for 2002 is to have a majority of states

self-certify they are conducting examinations according to two of the four areas of exam uniformity.

- For various reasons, not all states have the same amount of resources when it comes to performing market conduct examinations. A paramount objective is to address the problem of limited resources. The goal for 2002 is to finalize the Market Conduct Examination Resources Recommendation document, which will define the market conduct examination function, and develop an inventory of guidelines on the other consumer protection functions.
- In order to help offset issues dealing with limited resources, state insurance departments are seeking to more effectively monitor the activities of insurers doing business on either a regional or national scale through use of greater interstate collaboration on market regulatory activities. The goal for 2002 is to develop two to three best practices interstate collaboration models and have 30 states participate in at least one collaborative effort by December of 2002.

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July 15, 2002

The Honorable Richard H. Baker
U.S. House of Representatives
341 Cannon House Office Building
Washington, D.C. 20215-1806

Re: Follow up Questions to the June 18, 2002 Hearing on Insurance Reform

Dear Chairman Baker:

Thank you for your gracious invitation to participate in the June hearings on Insurance Reform. On behalf of ABIA's members, I appreciate your commitment to studying this complex subject.

During the hearing, you and several members of the Subcommittee asked me to respond to a number of questions left unanswered in my testimony. I am happy to accommodate you by providing those answers below.

A. Application of the Illinois Insurance Regulatory Regime Nationally

You asked what reservations I have with the Illinois model in the context of adopting that model nationally. As a general matter, ABIA supports the Illinois system as a model for rate and form regulation. Illinois has shown that price controls are not necessary to protect the consumers of insurance. In fact, Illinois has shown that the elimination of price controls can expand options and lower costs for consumers. Substantial testimony has been offered to your Subcommittee previously on this issue.

My reservation with the Illinois model, however, is that rates and forms are only one part of the problem with state insurance regulation. Other overly burdensome and unnecessary state regulations need to be addressed. For example, our members are subject to multiple, and conflicting, licensing requirements; seemingly infinite combinations of collateral forms requirements; open-ended examination requirements; and divergent market conduct requirements. All of these issues would be addressed in our optional federal chartering proposal. Therefore, to the extent I expressed any reservation with the Illinois model, I did so only because we would prefer federal legislation to address the full range of supervision and regulation, not just rate and form regulation.

Additionally, to the extent that your question suggests the creation of a national standard on rate and form regulation based upon the Illinois model, I would observe that national standards could take two forms, neither of which is preferable to optional federal chartering. On one hand, national standards could serve as minimum standards for the states, permitting the states to layer further regulation on top of those mandated by the Federal Government. As such, national standards would fail to achieve the uniformity and efficiency sought by ABIA and other advocates of optional federal chartering. In fact, minimum national standards would exacerbate the current patchwork of differing laws within which insurers and agencies have to operate by merely adding another layer of regulation to the existing system of state regulation.

On the other hand, national standards could be mandatory and exclusive. As such, national standards would not be an alternative to state regulation; they would replace it. This approach would intrude on the states to a much greater degree than optional federal chartering, which is designed to leave state regulation intact.

B. Local Character of Insurance

Representative Ross asked how a federally chartered insurer, subject to federal law and federal regulation, could be responsive to the varying needs of individual consumers and businesses in different states.

ABIA's optional federal chartering proposal recognizes the local character of insurance. It does so by requiring a federally chartered insurer that issues property and casualty policies, such as auto or homeowners' insurance or workers' compensation insurance, to fully abide by the policy terms and conditions imposed by the state in which the insurance is sold, other than rate and form regulations. In other words, if a state law or regulation requires automobile policies or homeowners' or workers' compensation policies to cover certain risks, a federally chartered insurer that sells such policies in that state would be required to comply with that state law. Put another way, our optional federal chartering proposal seeks to regulate the companies that issue insurance policies, not the content of the policies. States would continue to control the scope of property and casualty policies, other than through rate or form regulation.

Representative Ross specifically asked how claims and issues arising from them would be handled. I would note that large property and casualty insurers - those most likely to choose an optional federal charter - have local offices to service their customers when claims arise, so the manner in which claims are processed would not change for the customer. Under our proposal, the federal insurance regulator would be required to have at least six regional offices located around the country to respond to issues that arise. We further anticipate that the federal regulator would establish various sub-regional offices. The OCC, for example, has established over 70 regional and sub-regional offices to supervise the nation's national banks. Locally based supervisors would help to ensure that federally chartered insurers and agencies are responsive to local concerns.

Finally, certain insurance products, such as life insurance and annuities are not driven by local peculiarities, but rather are competing nationally with bank and securities products. These products, as I believe you suggested during the hearing, may be underserved by the current regulatory scheme in our increasingly mobile society.

C. Cost Savings

Representative Kanjorski requested that I elaborate on how a federally chartered insurer could experience a reduction in supervisory costs if, as we propose, federally chartered insurers would be required to cover the costs of federal supervision and continue to cover the costs of state supervision.

Our optional federal chartering proposal would require federally chartered insurers and agencies to pay assessments to a new federal insurance regulator to cover the costs of federal supervision and regulation. It also would require a federally chartered insurer to pay state insurance premium taxes, which are used to cover the costs of state insurance supervision. These premium taxes more than cover the costs of state insurance supervision.

Conversely, under our proposal, a federally chartered insurer or agency would no longer be required to pay any licensing fees or other non-tax assessments to state insurance regulators. Therefore, when we suggest that the overall supervisory costs for an insurer may be lower under our proposal, we assume the state premium taxes remain the same, but that the assessments paid to the federal insurance regulator will be less than the fees and other non-tax assessments currently paid to the various state insurance regulators. We have not actually calculated this potential cost savings. However, it seems reasonable to assume that the assessments imposed by the federal regulator would not equal the fees and other non-tax assessments paid to multiple states.

Furthermore, supervision and regulation by one federal regulator should result in additional operational costs savings for insurers and agencies. Our members incur significant operational costs complying with the various states' filing, licensing, advertising, and market conduct requirements. The personnel and systems costs needed to respond to a single federal insurance regulator should be less than those needed to respond to multiple state regulators.

D. Consumer Protections

Lastly, Representative Bentsen asked how our optional federal chartering proposal would protect the interests of consumers.

I am pleased to address this issue because I believe it is central to this debate. Our optional federal chartering proposal would protect consumers in several respects. First, and foremost, federally chartered insurers and agencies would be subject to federal consumer protection standards. In our proposed bill, those standards are patterned after existing NAIC model laws and regulations.

Second, the federal insurance regulator would be charged with ensuring compliance with the federal consumer protection standards. This would be done through regular examinations and the threat of enforcement actions. The opponents of optional federal chartering often cite the number of consumer complaints as evidence that a federal regulator could not adequately protect the many and varied interests of consumers. We believe the current volume of consumer complaints indicates that something is wrong with state consumer protection laws and enforcement. The fact is that several states do not conduct market conduct examinations or do so infrequently, and this allows certain insurers, agencies, and producers to engage in practices that are harmful to consumers. We believe that federal market conduct standards backed by examinations and the threat of enforcement actions would effectively deter such harmful practices, and provide consumers with better protection than they now receive under state law.

Third, we believe that optional federal chartering will create a dynamic tension between state and federal regulators that will be in the best interests of consumers. That has been the case in the banking industry. The healthy tension between state and federal banking regulators has stimulated the development of new products and services for consumers, and new and better supervisory techniques by both state and federal banking regulators. It has also fostered more efficient supervision as the respective regulators vie to keep their costs of regulation reasonable.

Finally, our proposal incorporates many of the supervisory reforms passed by Congress in response to the savings and loan crisis in the 1980s. Under our proposal, the solvency of federally chartered insurers would be ensured through risk-based capital requirements, outside audit requirements, regular examinations, and the threat of strong enforcement actions (civil money penalties could reach $1 million a day). This combination of examination, enforcement and threat of sanction is more comprehensive than the system currently in operation in the states.

I hope these answers are sufficient to your current needs. The ABIA will remain active in this debate. We look forward to the next opportunity to present our views to the Subcommittee.

Sincerely,

Glen J. Milesko

cc: Representative Paul E. Kanjorski
cc: Representative Ken Bentsen
cc: Representative Michael A. Ross

Statement of

M.R. Greenberg
Chairman and Chief Executive Officer

American International Group, Inc.

On Insurance Regulation And Competition for the 21st Century

Presented to the House Committee on Financial Services Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises

June 18, 2002

My name is Maurice R. Greenberg, Chairman and Chief Executive Officer of American International Group, Inc. (AIG). AIG is the world's leading U.S.-based international insurance and financial services organization, the largest underwriter of commercial and industrial insurance in the United States, and among the top-ranked U.S. life insurers.

I commend the Committee's leadership in conducting hearings on the future of insurance regulation, and I also appreciate the opportunity to submit this statement for the record.

I strongly support providing insurers with a federal charter option. A federal charter would promote greater efficiency in the delivery of insurance products and services and significantly reduce unnecessary regulatory costs. Although I recognize that the States are pursuing a number of insurance reform initiatives, the institutional constraints they confront make Congress the only body that can bring consistent and lasting improvements to today's regulatory regime.

It should surprise no one that the business of insurance has experienced extraordinary changes since the McCarren-Ferguson Act was enacted in 1945. While the fundamental objective of ameliorating risk remains the same, we have moved into a global economy with an ongoing stream of varied products and mechanisms designed to achieve this goal. A regulatory system that is not responsive or adaptive to the evolving demands of our ever-changing marketplace will fail consumers and insurers alike.

Unfortunately, the current balkanized system of state regulation has proven insufficiently capable to meet these demands, especially for insurers and consumers operating on a national or international basis. Duplicative, conflicting, and inconsistent state rules create uncertainty, delay the introduction of new products, significantly increase compliance costs, create state-by-state barriers to entry, and reduce benefits to consumers. Even where there is disagreement on whether the states or federal government are best equipped to fix this situation, few would support maintaining the status quo.

Several proponents of a federal charter have presented testimony to the Committee and I agree with their description of today's flaws and the need for federal involvement. Nevertheless, I want to emphasize three points that I believe are critically important for Congress to recognize as it considers whether to move forward in this area.

1. Maintaining an exclusive state-based regulatory system is inherently flawed and will never achieve national uniformity;

2. Federal regulation of insurance should seek to improve and not merely replicate existing state regulatory practices; and

3. Efforts to achieve comprehensive reform should not preclude Congress from taking incremental steps to improve certain insurance markets today.

Inherent State Flaws

I understand that many people sincerely believe that the National Association of Insurance Commissioners (NAIC) or the States acting in concert can develop a uniform and modernized version of state insurance regulation that works for all of us. I also want to acknowledge the efforts of those who are aggressively pursuing these changes today. However, actual experience strongly suggests that such efforts will fall short of where we need to be.

Simply put, the "States" are not a uniform entity. The States (and various territories) comprise 50-plus unique and dynamic sovereignties subject to a plethora of competing needs, demands, and institutional constraints. Even making the optimistic assumption that one day, all 50 state insurance regulators could agree and commit to a specific regulatory program over a course of years, these regulators are not necessarily the final word. I'm not aware of any state-based reform proposal that would preclude state legislatures from changing any such agreement before the ink dries, let alone constrain the actions of successor insurance regulators.

Indeed, issues -- many of which this committee has studied -- vividly demonstrate the real-world shortcomings of states trying to implement uniform, national insurance standards.

A prime example is privacy. Under the Gramm-Leach-Bliley Act, Congress directed the various functional regulators to write implementing privacy regulations for financial institutions under their respective jurisdictions. For insurers, this task fell to individual state insurance authorities. While federal functional regulators completed their full rulemaking process within the statutory deadline of November 2000, the story for the states was entirely different.

Working through the NAIC, a Model Rule for states *merely to consider* was not adopted until September of that year. Moreover, despite Congressional instructions for all regulators to develop rules that were consistent with one another, the NAIC made several substantial deviations from federal rules, including expanding definitions to cover commercial insurance products and proposing separate rules for health information. To compound this problem, several individual states made their own "minor" changes to the NAIC Model while other states required legislative action which invited more changes.

In the end, while federally regulated entities were provided substantial lead time to implement complex privacy compliance programs, insurers faced a federally mandated effective date with virtually no rules in place and conflicting proposals pending across most states.

Similar problems have been experienced regarding producer licensing and terrorism coverage initiatives, where the states have, again, shown troubling delays and inconsistency. In this often Kafkaesque environment, a federal charter option with strong preemption language is the only way to secure meaningful uniform standards.

Improving Regulatory Practices

Achieving uniformity at a national level is a big step in the right direction. However, Congress will miss a great opportunity to make significant regulatory advancements if it merely transposes existing state regulatory practices onto a federal system.

Chief among these state requirements is the prior approval of rates and forms, an unnecessary procedure for federally chartered commercial insurers. In addition, Congress should give serious consideration to the ramifications of replicating or utilizing the state guaranty fund system for federally licensed insurers. In our view, while the current guaranty system clearly affords insureds a certain level of protection, this protection comes with significant costs. Specifically, guaranty funds create perverse incentives for unsound underwriting practices. The cost of reckless underwriting is then ultimately passed onto good insurers (and their consumers) who abide by far more disciplined underwriting standards. Consequently, Congress should explore more effective options then the counterproductive guaranty fund approach.

Incremental Reforms

The majority of proposals seeking an optional federal charter for insurers contemplate comprehensive reform covering most types of insurance products. The comprehensive nature of these proposals is a significant contributing factor to the more dire predictions that Congress will be unable to deal with this issue anytime soon. However, Congress should not be so limited in its options.

Many of the questions contributing to delay involve the extent of consumer protections needed and how to enforce them. These issues tend to be of greater concern to individual consumers of personal lines products or smaller businesses, who are more reliant on the regulatory resources of the Government to protect against improper actors in the marketplace.

On the other hand, there are sophisticated market participants who are fully capable of freely engaging in commercial insurance transactions without the need for elaborate regulatory protections. For instance, I have not seen many interest groups advocating market conduct protections for Fortune 500 companies seeking general liability coverage in the 50 states from Triple-A rated insurers.

While our ultimate objective should be to provide an optional federal charter for all insurance products, Congress should not foreclose the opportunity to enact incremental reforms if consensus cannot be obtained on a comprehensive measure. Specifically, it may be easier for Congress to establish a more limited program covering commercial property and casualty lines for "higher-end" commercial users. For example, an optional federal charter could apply to commercial products encompassing a minimum threshold of premium paid or coverage provided. I would not envision the need for guaranty funds for these types of lines. Instead, the primary federal regulatory role would be to establish solvency standards and procedures to monitor the continued financial health of federally chartered insurers. This step would pose the smallest risk to individual consumers while providing the foundation for expanding the federal charter option to a broader range of products.

Before closing, I believe it's important to note the unprecedented attention Congress has given to the insurance industry since September 11th and its relationship to the debate confronting this Committee. The terrorist attacks clearly demonstrated to Congress that insurance capital is finite and that state-by-state mandated coverage and rules threaten the solvency of numerous insurers in the absence of federal intervention. Moreover, we've seen how the diminished number of willing providers of insurance coverage can have a significant impact on investment and economic growth. Although I would still be advocating the efficiency of an optional federal charter if the attacks of September 11th never occurred, the new threats we face only intensify the need for a more uniform, streamlined, efficient, and affordable system of regulation.

In conclusion, Congress has a unique opportunity to greatly improve the functioning of an industry that plays an instrumental role in promoting our nation's economic health. The costs of the balkanized state system of insurance regulation are borne not by insurers alone, but by insurance consumers across the nation and by the economy as a whole. It's time for Congress to bring insurance regulation into the 21st century marketplace and I urge the committee to seize that opportunity. I am confident that your efforts will bear fruit sooner rather than later.

AMERICAN
LAND TITLE
ASSOCIATION

June 17, 2002

The Hon. Richard H. Baker
Chairman
Subcommittee on Capital Markets, Insurance &
Government Sponsored Enterprises
House Committee on Financial Services
2129 Rayburn House Office Building
Washington, D.C. 20515

Dear Mr. Baker:

We respectfully request that the attached statement on behalf of the American Land Title Association ("ALTA")* be included in the record of the hearings held by the Subcommittee on "Insurance Regulation and Competition for the 21st Century."

We appreciate the opportunity to work with the Committee on this important issue. If you have any questions, please feel free to contact me on (202) 296-3671.

Sincerely,

Ann vom Eigen

Ann vom Eigen
Legislative and Regulatory Counsel

Enc.

*The American Land Title Association membership is composed of 2,400 title insurance companies, their agents, independent abstracters and attorneys who search, examine, and insure land titles to protect owners and mortgage lenders against losses from defects in titles. Many of these companies also provide additional real estate information services, such as tax search, flood certification, tax filing, and credit reporting services. These firms and individuals employ nearly 100,000 individuals and operate in every county in the country.

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AMERICAN
LAND TITLE
ASSOCIATION

Statement of the American Land Title Association on
"Insurance Regulation and Competition for the 21st Century"

The American Land Title Association* represents title insurance and settlement service providers. Of all the lines of insurance, none are as inextricably linked to state and local conditions as the title insurance industry. The focus of title insurance is the protection of the interests of owners, investors, lenders and others in real estate. The underwriting of title insurance involves a review and assessment of state and local records affecting titles to real estate. Title insurance policies are issued in connection with inherently local transactions – real estate settlements and mortgage loan closings. Reflecting the diversity of state and local laws and practices regarding real estate, the practices and processes by which title insurance is issued will frequently vary from state to state, and even from region to region within a state.

As a consequence, ALTA and its members strongly believe that regulation of the title insurance industry should continue to be the province of the various states. While federal regulation of insurance, or federal chartering of insurance companies, might be appropriate for the property/casualty insurance industry – as is suggested by Rep. LaFalce's bill "The Insurance Industry and Modernization and Consumer Protection Act (H.R. 3766) – such regulation and chartering are unnecessary for the title insurance industry, and would only serve to undermine the effectiveness of state regulation of our industry.

That is not to say that state regulation of title insurance cannot be improved. But most of the concerns about state regulation that have been advanced by those who support federal chartering are simply inapplicable to title insurance. Moreover, the National Association of Insurance Commissioners has been doing an effective job of coordinating and bringing greater uniformity of state regulation in those areas where such coordination and uniformity are appropriate.

In sum, we do not believe that there is a need for alternative federal chartering of title insurance companies, or for greater federal regulation of the title insurance industry. We look forward to working with the Committee as work on this issue proceeds.

For more information, please contact Ann vom Eigen, Legislative and Regulatory Counsel at (202) 296-3671.

* The American Land Title Association membership is composed of 2,400 title insurance companies, their agents, independent abstracters and attorneys who search, examine, and insure land titles to protect owners and mortgage lenders against losses from defects in titles. Many of these companies also provide additional real estate information services, such as tax search, flood certification, tax filing, and credit reporting services. These firms and individuals employ nearly 100,000 individuals and operate in every county in the country.

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United States General Accounting Office

GAO

Testimony

Before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, Committee on Financial Services, House of Representatives

To Be Released
at 2:00 p.m. EST
on Tuesday, June 18, 2002

STATE INSURANCE REGULATION

Efforts to Streamline Key Licensing and Approval Processes Face Challenges

Statement for the Record by
Richard J. Hillman
Director, Financial Markets and
Community Investment

GAO
Accountability * Integrity * Reliability

GAO-02-842T

Mr. Chairman and Members of the Subcommittee:

We are pleased to discuss our observations to date of ongoing efforts to develop and implement more uniform regulatory processes within the insurance industry. We have long held the view that state insurance regulation can be enhanced through greater uniformity. In the past, we have encouraged insurance regulators to implement more uniform regulatory standards, usually in the context of financial oversight. Over the past decade, the National Association of Insurance Commissioners (NAIC), through its Accreditation Program, has made considerable progress in achieving greater uniformity among state insurance regulators in carrying out their financial solvency oversight responsibilities. More recently, competitive pressures stemming from further consolidation of industries in the financial services sector and enactment of the Gramm-Leach-Bliley Act (GLBA) has kept attention focused on regulatory reforms in the insurance industry.

Many insurance industry participants advocate more uniform standards as a way to help streamline regulatory processes in an effort to make conducting business on a multistate or nationwide basis easier. Of particular interest are those processes related to licensing individual producers (agents and brokers) who sell insurance, approving new insurance products that insurers wish to market, and licensing companies to sell insurance. NAIC has undertaken several initiatives designed to streamline these regulatory processes. As requested, this statement focuses on three initiatives, highlighting their status to date, the issues encountered, and their prospects for success. These initiatives are commonly referred to as:

- *Producer Licensing Reciprocity and Uniformity,*
- *Speed to Market,* and
- *National Treatment of Companies.*

NAIC's *Producer Licensing Reciprocity and Uniformity* initiative aims to streamline the licensing process for producers that desire to sell insurance in one or more states in addition to their state of residence. GLBA calls for a majority of states to either adopt uniform producer licensing laws or reciprocate with other states in the licensing process by November 2002.[1] If the states fail to act, GLBA establishes a body called the National Association of Registered Agents and Brokers (NARAB), which would take over producer licensing functions from the states. NAIC intends to satisfy GLBA's reciprocity provisions first, believing that reciprocity will be easier to achieve in the near term, followed by actions to improve uniformity in the producer licensing process. Preliminary indications suggest that NAIC may be close to certifying enough states to satisfy GLBA's requirements. However, some state insurance departments in relatively large markets may not be eligible for certification, as they are not willing to lower their standards on certain licensing requirements such as criminal history checks using fingerprint identification. Industry representatives and NAIC acknowledge that until the states with relatively large insurance markets reciprocate in the producer licensing process, this initiative will not be fully successful.

State regulators are also trying to streamline regulatory processes to help bring new insurance products to market more quickly. NAIC's *Speed to Market* initiative has focused both on developing a more centralized filing and approval process for some types of life and health insurance products and on improving existing state-based approval processes for other types of products. NAIC's Coordinated Advertising, Rate, and Form Review Authority (CARFRA), a regulatory entity composed of state insurance regulators, is the mechanism through which they have tried to implement the concept of a single point of product filing and approval. However, a recent trial of CARFRA with 10 participating states revealed that insurers were not attracted by it. Many observers commented that CARFRA failed because companies still had to satisfy numerous individual state requirements, or deviations, in addition to the basic CARFRA review criteria. NAIC is now attempting to overcome this problem by developing an interstate compact, a legal mechanism under which states would cede product review and approval authority for certain types of insurance products to a regulatory commission, allowing it to eliminate deviations the individual states are unwilling to remove on their own. Other *Speed to Market* improvement efforts are directed toward existing state-based systems. Chief among these has been the development and implementation of the System for Electronic Rate and Form Filing

[1]GLBA gave NAIC, in consultation with state insurance commissioners, responsibility for reviewing and certifying the states that have met the uniformity or reciprocity provisions. States that agree to reciprocate on producer licensing matters agree to accept the licensing decisions of other states, even though the requirements may be different.

(SERFF). This system offers insurers the means to submit information such as rate and policy form data on proposed products electronically to regulators to help reduce the processing time associated with product filings. However, industry representatives continue to emphasize their desire for more streamlined product reviews and approvals that go beyond technical improvements to the rate and form filing process.

NAIC's *National Treatment of Companies* initiative, renamed *National Treatment and Coordination*, aims to facilitate the licensing process for companies desiring to conduct business on a multistate basis. Many of the same issues encountered under the *Speed to Market* initiative have also surfaced in this initiative. NAIC and state regulators largely abandoned initial efforts to create a more centralized insurer licensing and oversight process in favor of improvements to existing state-based licensing processes. The primary accomplishment of these improvement efforts to date has been the implementation of a common insurer license application form, the Uniform Certificate of Authority Application (UCAA). Currently, NAIC and state regulators are trying to reduce the number of additional state deviations beyond the UCAA requirements. Again, technical enhancements to form submissions have outpaced efforts to develop common review and approval criteria for company license applications.

Nationwide Producer Licensing Reciprocity Is Unlikely Without Higher Uniform Standards

In response to GLBA, NAIC has expedited efforts under its *Producer Licensing Reciprocity and Uniformity* initiative to streamline and simplify the process for allowing producers licensed in one state to become licensed in other states. GLBA required that states enact certain reforms simplifying and bringing more efficiency to the insurance producer licensing process. Traditionally, agents licensed in one state generally had to meet the separate licensing requirements for each state where they wanted to sell insurance. Since licensing requirements differed substantially, this requirement imposed significant burdens on producers in terms of time, effort, and monetary costs.

To comply with GLBA, a majority of the states must adopt either uniform licensing requirements or reciprocity by November 2002. With reciprocity, states must accept the decision of another state to approve a license and may not impose any additional licensing requirements. GLBA also gave NAIC responsibility for determining whether a state meets the uniformity or reciprocity provisions. If a majority of regulatory jurisdictions (29 states and territories) do not meet either the uniformity or reciprocity provisions by November 12, 2002, GLBA provides for the establishment of NARAB by the federal government, which would take over producer licensing functions from the states.

NAIC developed and promoted the Producer Licensing Model Act (PLMA) to help states comply with GLBA's reciprocity provisions. To date, many states have passed laws based on PLMA attempting to comply with GLBA's reciprocity requirements. However, NAIC has not yet officially announced the number of "compliant states" based on its review of the states' laws and implementation plans. Meanwhile, some states with relatively large insurance markets have expressed concerns that will likely keep these states from implementing fully reciprocal producer licensing practices. These states appear reluctant to "lower" their standards on certain antifraud and consumer protection measures, particularly those related to conducting criminal background checks using fingerprint identification and bond requirements for producer applicants. NAIC continues to address these concerns, which were not fully resolved through PLMA, in its efforts to develop more uniform state producer licensing requirements.

Most States Have Recently Passed New Producer Licensing Laws

NAIC's PLMA provides a blueprint or model for state legislation to help bring states into compliance with GLBA, provided it is enacted without significant changes. PLMA sets forth the basic nonresident (out-of-state) licensing requirements that mirror the reciprocity provisions set forth in GLBA.[2] States adopting PLMA are expected to grant licenses to nonresident applicants who have met the basic reciprocity requirements. To address any additional state requirements beyond the basic reciprocity requirements, PLMA also contains a waiver provision (in Section 16) that grants insurance commissioners authority to waive additional requirements for nonresident applicants. For instance, in Texas, the Insurance Commissioner has been granted authority to waive a recently enacted requirement that nonresident applicants be fingerprinted, although the waiver can be revisited each year.

At its summer national meeting earlier this month, NAIC reported that 46 states had passed some version of the PLMA. As required under GLBA, NAIC must now certify the states that have met GLBA's reciprocity

[2]NAIC's PLMA stipulates that nonresidents shall receive a nonresident producer license if they: (1) are in good standing in their home state, (2) submit the proper request for licensure and pay the required fees, (3) submit the application for licensure they submitted in their home state, and (4) reside in a state that awards nonresidents producer licenses according to these same requirements.

provisions related to producer licensing. NAIC is using a two-pronged certification process that encompasses: (1) a legal analysis of each state's legislation and regulation pertaining to producer licensing, and (2) a review of checklists or surveys that are being completed by each state regulator, describing how the insurance department intends to carry out its producer licensing functions. The questions in the checklist generally focus on the state's producer licensing requirements, authority to waive requirements, and postlicensing requirements. As of June 12, 2002, NAIC had posted checklists from 41 states containing information on how regulators intended to implement their state's version of PLMA.

Concerns of Some States Are Likely to Prevent Nationwide Reciprocity

While preliminary indications suggest that NAIC is close to certifying enough states to meet the GLBA's legal requirement, other concerns remain that will likely prevent full reciprocity on producer licensing matters in all states. Factors that may prevent full reciprocity include some states' reluctance to waive certain antifraud and consumer protection measures and state implementation practices that may be considered nonreciprocal.

Although a large number of states have passed some form of PLMA, some states did not remove or waive certain licensing requirements that may conflict with GLBA's reciprocity provisions. Our review of the checklists submitted to NAIC and discussions with industry representatives and regulators showed that a few states do not appear ready to waive certain existing antifraud and consumer protection requirements. Most commonly, these nonresident licensing requirements are related to criminal history checks (using fingerprint identification) and bond requirements for some producers. NAIC officials had anticipated that these requirements would be major areas of disagreement among states.[3]

We observed that some states were reluctant to eliminate their existing requirement to conduct a criminal history check on nonresident applicants using fingerprint identification. For example, California's insurance regulators said that while the state supports the goals of streamlining and creating more uniformity in state licensing procedures, California would not eliminate its nonresident fingerprinting requirement (and other key

[3]Related to this debate, we also observed some confusion and ambiguity among state regulators over the extent to which additional state consumer protection measures will or will not be allowed under GLBA (Savings Provision).

existing requirements) in order to satisfy the reciprocity provisions of GLBA. The regulators believed that eliminating this and several other existing requirements to achieve reciprocity with other states would weaken their current standards and consumer protection measures. [4] In Florida, a recently enacted PLMA expresses the state's desire to meet the reciprocity and uniformity provisions of GLBA but also incorporates nonresident fingerprinting requirements under its consumer protection provisions.[5] According to industry officials, some states continue to maintain fingerprinting requirements despite the passage of some form of PLMA legislation. Some state officials acknowledged that waiving nonresident producer licensing requirements to satisfy GLBA's reciprocity provisions could theoretically open a window of opportunity for undesirable individuals to enter the insurance industry. For instance, states where insurance regulators do not have the authority to conduct criminal background checks on producer applicants could provide such access. We have previously expressed concern that many insurance regulators lack the authority to conduct criminal background checks on industry applicants (in contrast to regulators in the banking, securities, and futures industries) and have supported actions to help establish such authority.[6,7]

Bond requirements for nonresident producers, intended to protect consumers and states from financial losses resulting from errors or misconduct, have also surfaced as a problematic issue in many states. According to industry observers, bond requirements have proven difficult to change or remove because they are established in state laws and regulations. NAIC commented that such requirements may not be

[4]The six nonresident producer licensing provisions that California Department of Insurance officials cited as critical were those requiring: (1) criminal background checks using fingerprint identification on applicants, (2) that organizational applicants designate a natural person to exercise authorities granted by licensure, (3) that a broker maintain a bond on file, (4) that certain agents and solicitors file agency appointments, (5) approval of fictitious names that applicants intend to use for conducting business, and (6) that an agent selling long-term care insurance receive specified training.

[5]Florida also has many other requirements it does not plan to eliminate. State regulators believe their requirements are necessary to protect Florida's uniquely large elderly population.

[6]*Insurance Regulation: Scandal Highlights Need for Strengthened Regulatory Oversight,* (GGD-00-198, Sept. 19, 2000).

[7]*Financial Services Regulators: Better Information Sharing Could Help Reduce Fraud,* (GAO-01-478T, Mar. 6, 2001).

appropriate for a producer seeking to conduct business on a multistate basis, because they do not take into account current commercial realities (e.g., a producer's annual volume of business is not taken into consideration in determining the amount of a bond). NAIC officials have also voiced concern about the cumulative impact of individual state bonding requirements in the context of facilitating multistate producer licensing.

Another issue relates to the postlicensing requirements producers must satisfy after obtaining a license. Licensing requirements waived or removed to satisfy the reciprocity requirements of GLBA could resurface as postlicensing requirements, undermining the benefits of regulatory streamlining. In our review of the checklists submitted to NAIC, we found that many states said they have the authority to waive requirements relating to nonresident licensing. A handful of states also reported having postlicensing requirements that could limit or place conditions on nonresident producer activities. For instance, one state reported that it could waive evidence of company appointments[8] as an application requirement but would ask for this evidence as a postlicensing requirement before the producer could conduct any insurance activity. Overall, we did not identify any significant use of additional postlicensing requirements, but such practices could inhibit the implementation of regulatory reciprocity among states.

Nationwide State Reciprocity Hinges on Concerns and Participation of Larger States

Although NAIC may be close to certifying enough states to avoid the creation of NARAB, other efforts to achieve greater uniformity must be successful before nationwide reciprocity is realized. Some states, often those with relatively large insurance markets, intend to maintain certain antifraud and consumer protection measures even though such requirements may be inconsistent with GLBA's reciprocity provisions. For instance, the California Department of Insurance did not support the adoption of NAIC's PLMA, designed to satisfy GLBA's reciprocity provision, because "the Model Act does not include several important enforcement tools that are contained in California law presently." Industry representatives have emphasized that the larger states need to reciprocate (accept the licensing decision of other states) before producers can fully

[8]An appointment refers to the authority an insurer gives to a producer to transact insurance business on the insurer's behalf.

benefit from improvements aimed at streamlining the licensing process to conduct business in multiple states.

NAIC's Uniform Producer Licensing Initiatives Working Group is currently addressing a number of issues related to producer licensing to help states achieve more uniformity. The group's areas of work include those related to background checks, prelicensing education, continuing education, and definitions for limited lines of insurance. These efforts will also have to address the concerns of states that have been unwilling to "lower the bar" on their existing regulatory requirements. Achieving nationwide reciprocity in the area of producer licensing is tied to the success of these uniformity efforts. However, it remains uncertain whether or when more uniform producer licensing practices will be adopted that satisfy the concerns of those states with the largest insurance markets.

Product Approval Reforms Use Both Centralized and State-Based Approaches

Through NAIC's *Speed to Market* initiative, state insurance regulators are trying to streamline regulatory processes associated with insurance product approvals to make products available to consumers more quickly. A principal aspect of this initiative is to develop a more centralized product filing and approval process for certain types of insurance products that are sold on a multistate or nationwide basis. NAIC established the Coordinated Advertising, Rate, and Form Review Authority as a vehicle for providing insurers with a single point of filing and approval. However, insurers balked at the initial CARFRA trial, saying the process still incorporated too many individual state requirements beyond a common set of review criteria. In response, NAIC is now exploring the use of an interstate compact as a mechanism for overcoming the issue of having to satisfy the product review and approval criteria of each individual state.

Another aspect of this initiative encompasses efforts to improve existing, conventional state-based systems. A notable outcome of these efforts is NAIC's System for Electronic Rate and Form Filing, or SERFF, which is designed to expedite the mechanics of submitting product rate and policy form filings to regulators. Other efforts to streamline product review and approval processes focus on reducing differences among the states' product filing requirements and identifying best practices.

Industry Was Not Attracted to Initial Trial of CARFRA's Centralized Review Process

Many insurers, particularly those in the life and health insurance business, claim they have been at a competitive disadvantage in marketing and selling investment-oriented products because banks and securities firms—their primary competitors in these product lines—can seek regulatory approval from a single regulator. In response, insurance regulators have tried to devise a one-stop filing and approval process for products that will be sold in multiple states. CARFRA is the mechanism that regulators devised to offer the industry a single source for product reviews and approvals.

NAIC launched a pilot of the CARFRA product approval process in May 2001 with a single point of filing mechanism, national standards, and disclosure of any additional state requirements or deviations. The CARFRA pilot consisted of regulators from 10 states that agreed to review new product filings on three types of life and health insurance products: term life, individual annuities, and individual medical supplements. CARFRA's centralized product review and approval process was based on national standards along with consideration of individual state standards. NAIC's goals were to be able to process a product filing within 30 days of receipt to CARFRA if the product conformed to national standards and to process any "outlier" filings within 60 days—those product filings that conformed to the national standards but required further review against the variances for the states in which the products were to be sold. After CARFRA's decision, each state had the option of either accepting or rejecting the product. The CARFRA process also took advantage of technology enhancements utilizing SERFF.

Since the launch date, only two filings have been received under the CARFRA process. According to NAIC, industry representatives said that CARFRA was not attractive because too many state deviations to the national standards existed. In general, the larger states participating in the CARFRA pilot program had the most deviations, often requiring the submission of additional forms and documentation beyond that necessary to satisfy the common review criteria. In addition, industry observers said that CARFRA was abandoned because participation in it was voluntary and it had no legitimate enforcement authority as a regulatory entity.

Regulators Are Now Exploring Interstate Compacts to Centralize Product Approval Processes

After rethinking the CARFRA process, NAIC has considered several alternative methods of streamlining the product approval process. Instead of totally disregarding the CARFRA process, NAIC opted to restructure it as an interstate compact, building on the processes and national standards already developed. NAIC is currently finalizing a proposal for an interstate compact that would establish a commission known as the Interstate Insurance Commission for Annuities, Life Insurance, Disability Income, and Long-Term Care Products to set standards and streamline review and approval processes for such products. NAIC is currently soliciting input on a draft interstate compact and intends to finalize a version that state regulators can vote on at the fall national meeting in September 2002. The compact would require states to delegate product review and approval authority on certain products to the new commission. As well as reviewing and approving certain types of insurance products, this entity would also have the authority to set standards.

The proposed interstate compact focuses on annuity, life insurance, disability income, and long-term care products. State insurance regulators have recognized that some life and annuity products are fundamentally distinguishable from other types of insurance products (e.g., property and casualty), since many products sold by life insurers have evolved to become investment products. Consequently, these investment-oriented products face direct competition from products offered by depository institutions and securities firms. According to NAIC, competitive pressures have provided the impetus to develop more streamlined product approval processes for certain insurance products. NAIC hopes the commission established through an interstate compact will help the states implement a more streamlined product review and approval process.

The new commission would develop and implement national standards for certain life and annuity insurance products that would supersede the standards of member states that enact enabling legislation for the compact (compacting states). These participating states would then consider adherence to the national standards as having the force and effect of statutory law. Up to now, the states have not generally eliminated their individual deviations to a common set of review criteria. Compacting states must enact the compact into law, effectively ceding their authority to review and approve the specified insurance products to the commission. As proposed, the commission provides for the establishment of a 14-member management committee to manage the affairs of the commission. Six permanent committee members would represent the compacting states with the largest premium volume for annuities and life insurance products. Other compacting states would fill the remaining board member positions on a rotating basis. Geographic considerations would also be used in establishing the management committee. Additionally, the commission can establish product standards only after legislative enactment of the compact by 12 states, and can review products and render approvals or disapprovals on products only after legislative enactment of the compact by 26 states.

The impetus for exploring the use of interstate compacts appears to be an increased sense of urgency to resolve current product approval issues and a realization among state officials that regulators have gone as far as they can to streamline product approval processes after the CARFRA trial setback. To overcome industry objections to state deviations beyond CARFRA's review criteria, state lawmakers would have had to change their states' product review and approval requirements to a common, uniform set of criteria. NAIC concluded that an interstate compact presented the best way to accomplish uniform product review and approval standards along with a single point of filing mechanism.

The success of NAIC's *Speed to Market* initiative largely hinges on whether or not a significant number of state legislatures agree to cede their regulatory authority to a separate entity on certain insurance product standards and approvals. Proponents of interstate compacts believe such an approach could be successful if the compact entity develops fair rules, disclosure and due process requirements, sunshine rules (allowing regulators to revisit and decide whether to continue with an interstate compact approach after a specified date), and other informational filing requirements and processes. In contrast, other industry observers believe states have little motivation to change to a single point of filing process, in part because of considerable differences in approaches toward product approvals and consumer protection measures. It remains uncertain how many states will pass enabling legislation to establish interstate compacts for product approval functions or whether states with large insurance markets will embrace this approach.

Technology Enhancements Lead Improvements Efforts on State-Based Systems

NAIC's *Speed to Market* initiative has also included efforts to improve existing conventional state-based product review and approval processes. Regardless of whether a more centralized process is used for certain types of life and health products, existing state-based review and approval processes will continue to be used for property and casualty products and many other life and health products for the foreseeable future. NAIC 's improvement efforts in this area, better known as Improvement to State-

Based Systems, aim to enhance states' rate, form, and advertising review units by reforming and standardizing their approval processes.

One of the most notable advances in improving state-based product review and approval processes has been SERFF, which offers a standard electronic form for new product filings with the states. SERFF enables regulators to receive, comment on, and approve or reject insurance industry rate and form filings electronically. SERFF is becoming increasingly popular, though it is not available for all types of products in each state. At its summer national meeting, NAIC reported that 50 states and the District of Columbia were licensed to accept product filings through SERFF and that 474 companies were licensed to use the system. Several industry representatives we spoke with acknowledged the merits of SERFF but explained that it still does not resolve more fundamental issues related to differences in product review and approval processes across states, many of which are based on statutory requirements. Additionally, to the extent that some states do not fully utilize SERFF for all lines of insurance, the cost benefit is diminished for insurers if they have to maintain a second paper product filing system as well. NAIC has also developed the *Review Standards Checklist* that gives insurers information on state rate and form filing requirements in a common format by product line.

Other efforts under NAIC's *Improvements to State-Based Systems* focus on reviewing and eliminating "unnecessary" product filing requirements that have accumulated over time. In particular, NAIC and state regulators are trying to identify and reduce those regulations that no longer provide useful oversight value as well as "desk-drawer" rules that have evolved over time but that are not specified by statute, such as a requirement to use a certain type of form.

NAIC has also developed a model law aimed at streamlining the product approval process for commercial property and casualty insurance. The *Property and Casualty Commercial Rate and Policy Form Model Law*, adopted by NAIC in March 2002, would ease some of the current state rate and form submission requirements if adopted by the states. The model recommends a "use and file" regulatory approach for commercial rates and a "file and use" approach for commercial policy forms. Under this model law, notices of commercial rate changes would be filed for informational purposes only and not subject to approval. Commercial policy forms would be filed 30 days prior to their use and would be subject to regulatory review and approval. One industry association pointed out that regulators from two states with large insurance markets said the model would not be adopted in their states. Trade representatives we spoke with could not speculate on the model law's prospects for passage at the state level, but indicated that its chances for approval faced challenges because commercial rates have risen substantially in the past year, exacerbated further by the September 11th attacks.

"National Treatment" Efforts Now Aimed at Streamlining Insurer Licensing Processes

NAIC's initiative to foster "national treatment of companies" has been revised since its inception and is now focused on making improvements to existing state processes related to insurer licensing. This initiative and others were highlighted in NAIC's Statement of Intent: The Future of Insurance Regulation, endorsed by NAIC in March 2000 in response to GLBA and changes in the financial services sector. Initially, efforts under the *National Treatment of Companies* initiative were directed at centralizing oversight for multistate insurers. Now renamed *National Treatment and Coordination*, the initiative is currently aimed at streamlining state-based review processes and application submissions for company licenses. Many of NAIC's efforts under this initiative have focused on implementing technology to support a common electronic application form, the Uniform Certificate of Authority Application, or UCAA. Like developments under the *Speed to Market* initiative, enhancements to the process of submitting forms have outpaced efforts to develop common review and approval criteria.

Improvements in Licensing Insurers Favored over Broader Centralized Oversight

Initially, the *National Treatment of Companies* initiative encompassed movement toward a single, unified process for supervising multistate insurers. Oversight functions such as licensing reviews, financial solvency monitoring, and market conduct oversight would have been conducted through a more centralized, streamlined process. However, as we previously reported in 2001, state regulators largely abandoned the goal of centralizing regulatory oversight for multistate insurers under this initiative and focused their efforts on improving existing company licensing processes.[9] Some efforts to streamline other regulatory processes for large, multistate insurers have been shifted to other NAIC working groups. For instance, NAIC is undertaking an effort to better coordinate and execute financial analysis and examination activities

[9] *Regulatory Initiatives of the National Association of Insurance Commissioners*, (GAO-01-885R, July 6, 2001).

among regulators that oversee affiliated insurers from multiple states under a holding company structure.

From its inception, NAIC and state regulators tried to devise an operational concept for a "national treatment" program that would offer insurers a state-based system that could provide the same efficiencies in many areas of oversight as a federal charter for insurance companies. Many of the options considered were based on a centralized regulatory function that often allowed the insurers' state of domicile to perform regulatory activities on behalf of the other states. State regulators ultimately rejected a national treatment concept covering a broad array of regulatory oversight functions based on deference to insurers' domiciliary state. Furthermore, a planned test of a national treatment program in 2001 was cancelled. Activity on this initiative is now focused on streamlining existing state-based company licensing processes for the benefit of insurers that wish to conduct business in multiple states.

Application Enhancements Have Outpaced Efforts to Develop More Uniform Insurer Licensing Process

Current efforts under NAIC's *National Treatment and Coordination* initiative are focused on developing more streamlined state-based application and review processes for insurer licensing. Much of NAIC's work on this initiative centers on the implementation of a common electronic application form, the UCAA. According to NAIC, this form is now available for use in all states. Closely tied to the development of the UCAA are efforts to develop a more common, uniform set of review criteria for insurer applications.

The UCAA offers insurance companies a web-based, electronic application form to obtain a license in any state. Although the application would still be submitted to and reviewed by individual state insurance departments, the format would remain the same and could be submitted electronically. The UCAA provides formats for newly formed companies seeking a Certificate of Authority in their domicile state, for existing companies desiring to expand their business into other states, and for existing insurers that want to amend their existing Certificate of Authority.

While the technology supporting a common application form has been developed, regulators have yet to agree on a common set of review criteria related to insurer licensing. In the absence of uniform criteria, insurers must separately submit supplemental applications beyond the UCAA information to individual states, often in paper form. Industry representatives maintain that these separate application requirements negate some of the benefits of using the UCAA form rather than conventional state application forms.

NAIC and state regulators continue striving to develop more uniform review criteria for licensing insurers. In April 2002, NAIC provided documentation on 91 additional state-specific requirements beyond those in the UCAA application.[10] Again, as was the case with the other initiatives, a principal issue in developing a common set of licensing review criteria has been the challenge of addressing each state's individual requirements. Through its Accelerated Licensure Evaluation and Review Techniques (ALERT) program, NAIC and state regulators are trying to reduce these additional state requirements (by 40 percent this year), particularly those not based on state statutes. While efforts to implement UCAA have been successful from a technical perspective, its common use in conjunction with a more standardized licensing review process has not yet materialized and remains uncertain.

Conclusions

In this statement, we have discussed three of the initiatives outlined in NAIC's *Statement of Intent* for regulatory modernization—licensing nonresident producers (*Producer Licensing Reciprocity and Uniformity*), approving new products (*Speed to Market*), and coordinating the oversight of companies that operate in multiple states (*National Treatment of Companies*). While it appears that NAIC is close to certifying enough states to meet GLBA's reciprocity requirements before November 2002 to avoid the creation of NARAB, several states, including some of the largest, either will not have full reciprocity or will satisfy this requirement only by temporarily waiving—not eliminating—statutory requirements for nonresident producers. Similarly, the states' effort to streamline the product approval process—CARFRA—failed largely because, even in the 10 states that conducted the pilot, individual states would not give up state-specific requirements that they believed were important. Finally, as we pointed out in our earlier reports,[11] the original objectives of National Treatment—providing regulatory treatment for "national companies"

[10]At the time, NAIC's figures did not include additional requirements from one other state. NAIC's breakdown of these additional requirements revealed that 30 were required by state statute or regulation, 16 were characterized as administrative or informational, 15 were financially oriented, 10 were required by other state agencies, 10 were required for identification purposes (most often fingerprint identification requirements), and 10 others were miscellaneous.

[11]GGD-00-198 and GAO-01-478T.

comparable to that under a single federal regulator—were quickly narrowed to focus on the implementation of the UCAA, a single application form that companies can submit to multiple states when applying for a license to sell insurance. Even in the case of the UCAA, which has been adopted by all states, individual states have retained additional state-specific requirements because they believe that the UCAA, by itself, lacked some important features, such as fingerprinting of company principals.

While the specific details of state regulators' actions in each of these areas have varied, there have been similarities in the pattern of accomplishment. In each case, improvements, sometimes dramatic, have been made in efficiency by streamlining and applying technology, for example, standardizing forms and using technology to submit applications for licensing or product approval. There has been considerably less success in reaching agreement on the more substantive underlying issues. In each case, some states that consider themselves to be stricter or to have more consumer protections have been reluctant or have refused to lower their standards. If the objective of NAIC's agenda of regulatory reform and modernization is simply to have all states agree, then what has occurred thus far may be considered a failure. However, if the objective is more uniformity and reciprocity with an overall improvement in regulatory performance, then the holdout states may be the only defense against the weakening of both regulatory oversight and consumer protections. We do not suggest that every individual state deviation or objection is appropriate or desirable. However, if some states did not object to giving up fingerprinting, for example, as a means of conducting in-depth criminal and regulatory history background checks of agents or company owners and management, consumers would likely be more at risk and regulation would be less effective. In that case, neither uniformity nor reciprocity would represent regulatory progress.

For its part, we believe NAIC has made a concerted effort in promoting more uniform regulatory processes and requirements. NAIC has also demonstrated successes in implementing technology to improve efficiencies in licensing and product approval processes. Now, continuing success on many regulatory streamlining efforts desired by industry depend on state legislatures' willingness to trust other regulatory entities, either other states or entities such as the commission created by the compact, with certain regulatory functions and decision-making authority. Many states, often with the largest insurance markets, are not likely to take such a step unless they are convinced that other states and regulatory entities operate under a set of standards comparable to their own.

State regulators' efforts to date suggest that in certain areas, state regulators and NAIC may not be able to achieve uniformity through common consent (e.g., criminal history checks using fingerprint identification, uniform criteria for product approvals and company licensing, and others). To the extent this is true, ongoing federal oversight and, possibly, federal intervention (as in the case of GLBA's call for NARAB should state action fall short) may be needed to provide impetus for positive change and continuing improvement in state regulation of insurance.

Contacts and Acknowledgments

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NAIFA

NATIONAL ASSOCIATION OF INSURANCE AND FINANCIAL ADVISORS

STATEMENT OF THE NATIONAL ASSOCIATION OF INSURANCE AND FINANCIAL ADVISORS

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES

FINANCIAL SERVICES COMMITTEE

UNITED STATES HOUSE OF REPRESENTATIVES

June 18, 2002

This testimony is submitted on behalf of the National Association of Insurance and Financial Advisors (NAIFA) (formerly the National Association of Life Underwriters). NAIFA is a federation of nearly 1,000 state and local associations that together have almost 80,000 individual members who sell and service a broad spectrum of financial products: individual and group life and health insurance, pension plans, securities products, business continuation insurance, business and estate planning, retirement planning, deferred compensation, and employee benefits.

Originally founded in 1890, NAIFA is the nation's oldest and largest trade association of insurance agents and financial advisors. NAIFA's mission is to improve the business environment, enhance the professional skills and promote the ethical conduct of agents and others engaged in insurance and related financial services who assist the public in achieving financial security and independence. NAIFA appreciates this opportunity to offer its views on a topic of great interest and critical importance to its members.

I. Introduction

It is essential in this new world of financial services regulation ushered in by the Gramm-Leach-Bliley Act that financial institutions have the opportunity to compete with one another on a level playing field. Unfortunately, the reality is that banking institutions and securities firms currently enjoy a distinct advantage over state-regulated insurance agents, who are hampered by palpable flaws in the current state-based system of insurance regulation. As a result, insurance companies – and, derivatively, NAIFA's members who sell and service their products – are at a significant competitive disadvantage compared to their counterparts in other industries.

As the Committee is aware, there is renewed interest among some members of the insurance industry in the adoption of a federal approach to insurance regulation. Supporters of optional federal chartering maintain, for example, that the inefficiency and lack of uniformity in the current state-based system is best achieved by establishing a federal insurance regulator. Invariably, federal models propose to charge a distant, detached and inexperienced federal regulator with the implementation and enforcement of a single set of rules that would apply equally across all states and all insurance markets. While the promise of increased uniformity and efficiency sounds appealing, proponents of this approach appear to have lost sight of the undeniable *benefits* of the state-based system and have overlooked the increased havoc that a federal system could cause.

Without question, significant weaknesses exist in state insurance regulation today. Unnecessary distinctions among the states and inconsistencies within the states thwart competition, reduce predictability, and add unnecessary expenses to the cost of doing business. Similarly, outdated rules and practices do not serve the goals of regulation in today's financial services marketplace. Nevertheless, there is much that is good about the current state-based system that would be lost through the creation of a federal regulator, including an enforcement infrastructure upon which consumers throughout the nation heavily rely to protect their interests.

Historically, NAIFA has supported state regulation. It continues to believe that the states will be more responsive to its members' concerns than a federal regulator would be and that, ultimately, the states are the best laboratories for change. Thus, NAIFA remains skeptical at this juncture that the creation of a federal bureaucracy is necessary to achieve reform. That said, NAIFA is currently in the process of reviewing the various regulatory options and is developing a position on the most workable solution.

II. Flaws In The Current System

A. Duplicative Licensing Obligations

Currently, insurance agents and brokers must be licensed in every state in which they conduct business. In order to obtain and maintain licenses, they must comply with different and often inconsistent standards in numerous states and contend with duplicative licensing processes. For NAIFA's members that place and service group health and group life benefits, which necessitates doing business across state lines, multi-state licensing obligations are unbearable.

For NAIFA's members who sell and service individual life and health products and securities, the current state of affairs is equally disconcerting. Over 75 percent of NAIFA's members are licensed not only at the state level but are also registered representatives of broker-dealers with the National Association of Securities Dealers (NASD). These individuals regularly face duplicative, inconsistent and often conflicting obligations – such as with regard to privacy obligations – that are unnecessary to protect consumers and are driving up the cost of doing business.

B. Speed to Market

One of the most significant impediments to successful product launches is a slow response to filing. It is not uncommon for a company to file a new product for approval but not hear back about its application for two or more years. This delay is a significant problem in states where approval is required before a product can enter the marketplace. Cumbersome inefficiencies create opportunity costs, which ultimately drive consumers into alternative market mechanisms. These costs can be avoided and, moreover, far exceed what is necessary to protect the public. For NAIFA members, the speed to market problem is most acute with regard to life insurance products, where there is little or no regional variation warranting disparate treatment in the first instance. Agents selling sophisticated life insurance investment products are at a distinct competitive disadvantage compared to their counterparts who offer non-insurance investment products, because it is almost impossible for them to keep pace with the range of comparable products able to be brought to market so quickly in the securities marketplace.

C. Countersignature Laws

NAIFA opposes state requirements that discriminate against non-resident agents, such as countersignature laws, which are in place in a handful of states. Countersignature laws require resident agents to countersign insurance policies sold by nonresident agents. The resident agent is then entitled to a percentage of the commission, despite the fact that the resident agent typically does none of the work and has no relationship with the client. These laws represent the height of protectionist state regulation. From a practical standpoint, they add unnecessary expense – millions of dollars in costs – to the agency system while adding no benefit or value whatsoever to consumers, whose interests are adequately protected by the full range of state regulations with which all agents must comply.

D. Criminal Background Checks

One of the most persistent problems in the current state system has been the failure of many states to conduct criminal background checks of applicants for insurance licenses. The ability to conduct background checks is vital to consumers of financial services, who rely on regulators to keep bad actors out of the business and to safeguard consumer interests.

Although federal law essentially dictates that criminal background checks must be done on all participants in the insurance industry, state insurance regulators typically have been denied access to the tools that would enable them to conduct such background checks. They also have little authority to coordinate their efforts and share information when such checks are conducted. In comparison, the securities and banking regulators conduct criminal background checks on each and every individual employed in their industries, and they have full access to the FBI information that enhances their ability to do so.

III. Nature of the Solution

As we indicated, NAIFA is in the process of developing its position on the most effective means of redressing these and other concerns with the state-based insurance regulatory system. It is exploring a variety of options and is open to a wide range of potential solutions. Having traditionally been an ardent proponent of state regulation, NAIFA is hesitant to abandon the current state system so quickly. In addition, it is apprehensive about the notion that any newly-created federal bureaucracy will be able to replace the 150 years worth of experience that the states have as insurance regulators. NAIFA is not convinced that progress necessitates an entirely new regulatory infrastructure. Instead, recent experience demonstrates that the path to reform may be shorter and easier to traverse at the state level.

State-based options available for improving the speed to market of new products, for example, include encouraging – or even requiring – the states to employ a single point of filing regime for new insurance products. In a single point of filing regime, approval of a new product by the reviewing state within a specified period of time would enable a company to use the product in multiple states. This type of system potentially could be used for all product lines, or just those products – like life and health products – that tend to be more homogenous and offered on a nationwide basis.

Significant strides have already been made in this area and future progress is anticipated. A pilot program unveiled last year by the National Association of Insurance Commissioners (NAIC) demonstrates the states' ability to work together to solve speed to market concerns. The Coordinated Advertising, Rate, and Form Review Authority (CARFRA), which has gained the support of numerous states, seeks to identify "best practices" in rate and form filing, including those which may be legislatively implemented in the individual states for greater uniformity and efficiency in filing and review procedures.

In addition, reforms in producer licensing and accreditation laws have been achieved by most states' adoption of model legislation proposed by the NAIC. Such efforts have removed unnecessary licensure requirements placed on non-resident agents and therefore increased their ability to operate efficiently in multiple states. Further improvements should build on this effort by applying similar principles of regulatory efficiency to all agent requirements and by removing remaining market access barriers.

What is clear is that additional reforms are needed; what is not clear is that change will be best achieved by adding an inexperienced and detached federal regulator to the equation.

Of course, NAIFA recognizes the important role that Congress can play in state regulatory reform. Perhaps the best example of this is H.R. 1408, the "Financial Services Antifraud Network Act of 2001," which NAIFA strongly supports. The bill would authorize the creation of an information sharing network among all financial regulators, thereby facilitating background checks and increasing their efficiency. But it would do so without creating a new database; it would simply provide links among existing regulatory databases. In addition, the bill would empower state insurance commissioners to access – through the NAIC – FBI databases containing the information about arrests, convictions and sentencing that they need to conduct such background checks efficiently and effectively. The H.R. 1408 experience demonstrates that perceived problems can be remedied without jettisoning the state-based system.

IV. Conclusion

NAIFA is committed to finding an acceptable solution to the current problems associated with state regulation of insurance. It maintains, however, that creating a new federal bureaucracy is not necessarily the right answer. In NAIFA's view, the most successful solution will preserve the best characteristics of the current state system, including its innovation, experience and responsiveness and by drawing on its inherent strengths rather than by so quickly abandoning them. By working with state insurance departments rather than against them, the insurance industry will be better able to meet the challenges of a rapidly changing financial services environment.

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